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THE QUICKSANDS OF THE CITY

By the Same Author

THE MEANING OF MONEY
STOCKS AND SHARES
MONEY CHANGING
WAR AND LOMBARD STREET
POVERTY AND WASTE
INTERNATIONAL FINANCE
WAR-TIME FINANCIAL PROBLEMS
THE BUSINESS OF FINANCE
OUR MONEY AND THE STATE
THE CASE FOR CAPITALISM
BANKERS AND CREDIT
HINTS ABOUT INVESTMENT

The QUICKSANDS of the CITY and a Way Through for Investors

by

HARTLEY WITHERS

City Editor of *The Times*, 1906–10; Editor of *The Economist*, 1916–22.

'Out of this nettle, danger, we pluck this flower, safety'

SHAKESPEARE, *I K. Hen. IV.*, Act. 2, Sc. iii.

LONDON

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PREFACE

YES, I know it is true that I have already written, nearly twenty years ago, a book called *Stocks and Shares*, and in 1926 one on *Hints about Investments*. But even in the last three years security prices have learnt to dance to new tunes, and the concert of central banks has obliged the money market with some amazing new discords. A new doctrine, that Governments should quicken trade by spending borrowed money, has been heralded by a blast of trumpets blown by distinguished economists; and the assessment of share values has climbed from dividends to earnings and then up the greasy pole of possibilities.

In this whirl of novelty the investor is bewildered by a multitude of counsellors, and the speculator is more than ever helpless under the shears that fleece him. And much new light has been given, sometimes shining in places where the general public was not likely to see it. Mr. Raynes's paper on 'Common Shares as Investments' has kindled on this side of the Atlantic the torch lit by Mr. E. L. Smith in America. Sir Mark Webster Jenkinson has turned the searchlight of his wit on balance-sheets, making their obscurities more glaringly obscure. And a new

public has gathered profits and suffered losses. If I can catch a few members of it in a chastened mood, and help them to know better next time, I am more than justified.

H. WITHERS.

GUILDFORD, 30*th October* 1929.

THE QUICKSANDS OF THE CITY

CHAPTER I

NEW SAVERS AND GAMBLERS

Recent Financial Revolutions – Their Consequences – The New Public – The Harvest and the Reapers – What this Book sets out to Show.

In May of this 1929th year of so-called Grace, I had the honour of giving, before a very learned society, an address on the subject of 'The Financial Revolution and its Consequences'; and was surprised to find that many members of the society had been puzzled when they received, before the meeting, notice of the subject to be discussed, because they had not known that a financial revolution had happened.

Revolutions, like most other things, are chiefly a question of definition – much depends on what one means by the word; but it seems to me that there have been two, if not three, big revolutions in finance lately which have hardly been noticed by members of the general public, but have had very serious effects on business all over the world. They have made investment in some ways much more puzzling, and in others a rather easier problem. They have made borrowing by Governments more expensive, and so have made debt conversions

more difficult. They have made speculation – in the sense of gambling for 'differences' in the stock markets – more than ever a fool's game, except for those who can give all their lives to the study of it, or are so rich that they do not mind how much they lose.

Revolution number one is a change in the theory of investment, which has set up a cult of the Ordinary Share, which used to be looked on as essentially speculative, as the safest purchase for the real investor.

Revolution number two is the westward shifting of the financial centre of gravity, owing to the huge wealth and financial power gained by America in the course of the War, and enormously increased thereafter by her energy and success in production and business.

Revolution number three (which will be accepted or rejected as such according to the taste and fancy of the reader) is the appearance in the United States of a notion that it is the business of a country's banking authorities to see, not only that the public is adequately supplied with money and credit on reasonable terms, but also that the public shall not make naughty uses – or uses that the banking authorities think naughty – of the money so supplied.

Largely owing to these revolutions the money markets and stock exchanges of the Eastern hemisphere are, at the beginning of August 1929,

breaking up for their summer holidays in a state of acute depression and discomfort. The stream of capital has ceased to flow. Credit is dear and sticky, and the floors of Throgmorton Street and of the Continental Bourses are strewn with the bones of unfortunate speculators picked dry in the process of getting rich quick. It goes without saying that, with these things happening in the financial field, the trade of the world is clogged and hampered, and development and enterprise are sulkily waiting for better days. Even in America, which has inflicted (quite unwittingly) most of the mischief on the rest of the world and feels least of it herself, many small speculators are said to have been hit very hard in the course of those periodical 'shake outs' which sweep the floor of Wall Street like a winnowing fan. Every now and then we are told that most of the floating stock has gone into 'strong hands,' which means that the weak have gone to the wall, which is their only destination if they will insist on speculation.

These events are all the more disastrous and untimely because the investing public is in all countries to a great extent new to the business, and has not made up its mind whether it is trying to invest or to speculate. It has not clearly grasped the distinction between these two operations – and the line that divides them is exceeding faint and wavy – and is very likely to be misled, when it makes what are really mistakes in speculation, into a belief that

all investment is so full of pitfalls that the best thing to do with any surplus income is to squander it on immediate enjoyment.

Both in the newness of the investing public and the extent to which its experience has been preyed on, the United States, as was to be expected, give us the most striking examples. According to American writers, the general public there did not bother much about investment and the stock markets until the United States came into the War, and the Liberty Bond 'drives' taught the public the meaning of subscriptions to Government issues.[1] When the War was over and the whole world, after a short pause of uncertainty, went mad with a fever of speculation, the great wealth that had been gathered into new hands offered an especially promising harvest in America to people anxious to relieve the public of its monetary responsibilities. And the reapers were many and eager. Mr. E. H. H. Simmons, President of the New York Stock Exchange, in his book entitled *Modern Capitalism and Other Addresses*, tells us that 'many estimates have been made of this gross income of the security-swindling industry in America. The United States Treasury has stated that in 1918-1919 approximately $400,000,000 of Liberty Bonds were taken from investors through various swindling methods.

[1] See *The Common Sense of Money and Investments*, by M. S. Rukeyser, p. 38 *seq.*

Some years ago both ex-Secretary of the Treasury McAdoo and the Fraudulent Securities Committee of the Investment Bankers' Association agreed in estimating the annual public loss at $500,000,000. But the United States Post Office Department, I believe, as well as several prominent private business men, have been inclined to double this figure.'

Even £100,000,000 a year is a large order even for so rich a folk as the Americans, and if it is to be doubled it becomes a social disaster on a great scale. Moreover, Mr. Simmons was speaking in 1925 before the speculative fever in America, that has had such weird effects on the world's monetary history, was really under way.

In England, as we all know, the high rates of direct taxation – income-tax, super-tax and death duties – now bite a big slice out of the surplus income of the old investing classes. On the other hand, the work done by the National Savings Committee, the Building Societies and other agencies of this kind has taught many new millions to save, though it was lately estimated by the Colwyn Committee on National Debt and Taxation that the nation as a whole is saving 150 to 200 millions a year less (after making the necessary adjustment for the altered buying power of money) than it did before the War. Which fact, combined with another, that a much smaller proportion of our savings is being lent abroad, may have a good deal

to do with the depression of our export trades. But that is another story. We have certainly got a new class of savers and investors. We have also got a new class of speculators, fed on financial tips furnished by an enterprising Press. In the spring of 1928, when the speculative sun was still shining, it was difficult to find any railway carriage or bus in which people were not talking about shares to buy. Now, most of these unfortunate folk are wishing they had never heard of them.

In Germany the old Rentier class was wiped out, as such, by the depreciation of the mark, which divided the value of its investments by millions.

In France it lost nearly all that it had put into Russia and Turkey, and saw the value of its French Rentes – the corner-stone of its financial temple – divided by five by the stabilization of the franc at 124 to the pound. And so now it is said that one reason why money is tight in France is because the French public is hoarding notes. Incorrigibly thrifty, the Frenchman, disgusted with the results of investment, puts notes into a stocking.

It is of the highest importance to the world's economic progress that the new investors in all countries should be saved from the snares that beset them. We want to see mankind knee deep, waist deep, eyebrows deep, in heaps of good and fine things to enjoy. Triumphant science, inde-

fatigable invention, and immeasurable productive power make this easily possible (though nationalism, with its tariff barriers, is always in the way) if only we provide them with the necessary capital. Bad investment will not help this process. The losses that follow it disgust savers and turn them into squanderers.

If this book can show: –

(1) That investment is much too difficult a business to be done by an amateur;

(2) That speculation – in the sense of gambling for the rise in stocks and shares – is so risky that it is not worth while for ordinary folk, because the odds are always against the outsider and in favour of those who are on the spot to skim the cream off markets;

(3) That the revolutions mentioned on page 1 have made the movements of all those things that 'go up and down in the City' much more complicated and mysterious;

(4) That the development of the Investment Trust, if carefully handled on sound lines, opens a door through which investors may seek for safety through diversification of risk,

it will have done its work.

CHAPTER II

THE INVESTOR'S QUANDARY

The Old Doctrine – Shaken by War's Results – The New Theory – Its Effects – Risks faced by those who follow the Old – The Future of the Rate of Interest – A Change in Financial Policy – The Modern Investor's Ambition – Difficulties in Achieving It.

TIME was when the investor's problem was fairly simple, for in those sleepy pre-War days he used to be told that all common stocks and ordinary shares were speculative, and should be left to those who could afford to speculate. He was advised to think only of getting by his investments a sure and certain income, was reminded of the Duke of Wellington's saying that high rate of interest means high rate of risk, and advised not to fash himself about the price at which his investments might stand as long as that first requisite – a certain income – was not in doubt. If his investments fell owing to reasons not connected with their reputation for soundness (such as those mysterious happenings in the money market which have such an upsetting influence on the prices of securities) he might console himself on his death-bed with the pleasing thought that the harpies of the Inland Revenue Office would get so much less out of his heirs in death duties;

and if the heirs took the stocks over and lived on the income, prices would not matter to them.

From this doctrine came the practical result that the investor who followed it bought Government securities and other 'trustee' stocks, and, if he were inclined to be frisky, a small proportion of the first charge stocks – bonds, debentures, and preferences – of some of the leading industrial and commercial companies and foreign railways. Those of the Home Railway companies were included among trustee securities, and so were, in the eyes of most investors, and many even of their professional advisers, hall-marked as watertight investments.

There was a great deal of sound sense in these principles, but they were based on certain assumptions of political and monetary stability which were set at nought by the War. A trustee who bought (as I did) Great Western Railway 5 per cent. preference stock at 199½ in the 'nineties of last century was justified in feeling that he had done very well for the beneficiaries under the trust for which he was acting, by getting them a yield of 2½ per cent. on the trust funds. At the time when I bought, this was almost the only trustee stock that would do it, and I remember that my co-trustee felt just a little nervous about it, as if it must be slightly speculative to pay so much. That stock has certainly produced its 5 per cent. interest with clockwork regularity ever since, but in the mean-

time income-tax has gone up from eightpence to four shillings in the pound, having soared in the meantime to six shillings; super-tax has been invented for the further discomfiture of such investors as are thereto subject, and the money in which the 5 per cent. is paid is quite a different article. In the 'nineties one's dividend warrants gave one a right to those beautiful gold pieces that really used to buy things. Now we handle bank notes which at least are better than the Treasury notes for which we gave up our sovereigns; but the pound of to-day has lost about a third of its pristine buying power, and is lucky to have got off so lightly when we compare it with the German mark, which was wiped out by inflation, and the French franc, the value of which was divided by five.

All these things, it may be retorted, would have happened to the investor what stock soever he bought, when the buying power of money is depreciated, because Governments manufacture, or cause banks to manufacture, too much of it. Anybody who invested before the depreciation happened is bound to lose more or less owing to the consequent rise in the prices of goods, and the only protection against this danger is not to invest in securities at all, but to buy real property – houses and land, or furniture or jewellery, or any other commodities that we can pack into our houses. But this is not quite true, for those

investors who had ordinary shares in certain forms of enterprise – such as ships or coal-mines or engineering plants – did very well during the War; and it was probably this fact, which then emerged so conspicuously, that called into being the school of investment theory which maintains that ordinary shares are the 'only wear' for the scientific investor.

As to which theory, and its foundations and justifications, a good deal will have to be said later. For the present it is enough to say that it has arrived, and is very popular, even in investment circles which used to be regarded as most straitlacedly conservative. It has already had very far-reaching effects on the market for all kinds of securities in all financial centres, forcing up the prices of ordinary shares to heights that in many instances have seemed absurd to old-fashioned investment experts, and tending to depress those of Government and municipal loans, and the fixed-interest-bearing prior charges of railways and all kinds of industrial and commercial ventures.

In so far as it has this latter effect, it makes the problem of investment simpler for those investors who are content to work along the old-fashioned lines, still believing in the safety of 'gilt-edged' securities, and being content to ignore the risk of another great debauch of monetary inflation which might halve the buying power of their interest, and also the risk of depreciation in the prices of their securities quite apart from any such debauch.

How far are they justified in running these risks?

It is fairly safe to expect that inflation such as was seen during the War is not likely to happen again unless we have another such war. As to which, who can see and say? We all hope; but, as one who was wrong enough to think in 1914 that the world had grown too wise ever to be dragged into big war again by a set of absurd autocrats and muddle-headed statesmen, I should like to protect any income that I may earn from investments against the risk of war, if it is possible to do so. For if such war does come again it is fairly safe to expect that, in spite of all that was learnt in the last one about inflation, we should have inflation again; and the holder of fixed-interest securities would again find his interest (we may hope) punctually paid, but with its buying power cut in half, or wiped out altogether, by a rise in prices, because Governments find it easier to make new money than to take money in taxation. Anyone, therefore, who specializes on what are sometimes called 'Safety First' securities will be well advised to be a generous subscriber to the League of Nations Union, and an active preacher of the gospel of peace.

But, apart from the risk of war, there is also that of depreciation. It may be that, as was suggested at the beginning of this chapter, the real ideal investor does not mind about the prices of his holdings, does not even watch them or care

about them, but draws his interest and is content. But in these times there are not, I think, many (if any) such investors, apart from trustees bound by strictly drawn trust deeds. But since some may still survive, let us look at this question of depreciation as threatening the holder of fixed-interest securities.

Most people will tell you that this danger does not exist and that the wind is quite on the other cheek – that the general rate of interest is bound to fall in the years to come (barring, of course, another world war) as capital accumulates, confidence returns, and political and social stability are re-established. If so, it inevitably follows that the prices of fixed-interest securities will rise, and all that the holder of them needs to consider is that they shall be, if possible, irredeemable, or, if not, redeemable at as remote a date as possible, because a security that may shortly be paid off at par evidently will not rise above it.

The view is held, I believe, by the majority of those best competent to peer into the monetary future and is supported by historical precedent for what that is worth. But here again one may say, with Racine's Petit-Jean,

Ma foi, sur l'avenir fou qui se fiera!

for there are several new elements in the position now which may tend to defeat, or at least postpone, history's habit of repeating itself. One is this new

investment theory which tells us to eschew fixed-interest securities and buy 'equities,' which means ordinary shares or common stocks. The popularity of this theory has already, I believe, done much to retard the fall in the rate that can be earned by buying fixed-interest securities and turned it into a fall in the rate of dividend that a buyer can get from ordinary shares. As will be shown, even institutions like insurance companies, which formerly confined themselves to the straight path of the 'gilt-edged' investment, now go dallying after ordinary shares, and so there is not such a wide market as there was for trustee securities.

And at the same time it seems likely that securities of the trustee type will be multiplied, for many years to come, at least as rapidly as the market can digest them. In all countries industry is always saying, with one side of its mouth, that private enterprise is the only hope for progress and that the best thing that Governments can do is to leave things alone and reduce taxation; and, with the other, that the Government ought to provide it with better roads or cheap credit, or information, or trade commissioners, or other forms of assistance, many of which industry's ancestors would have provided for themselves much better than a Government department. In Great Britain at least two political parties have been, in varying degrees, anxious to prove that they are eager to spend public money raised by loan. At the late General

Election Mr. Lloyd George's scheme, which was much the biggest and most carefully worked out for producing prosperity by spending borrowed money, was backed by some highly distinguished economists. And lately, in July 1929, Mr. J. H. Thomas was calling out for schemes to be furthered and financed by means of credit and guarantees provided by Government.

So we have at the same time a market for gilt-edged securities narrowed by a new theory that they are not really as safe as common stocks, and a complete reversal of the principles on which Government debt used to be created. The old-fashioned notion was that Government expenditure should be met out of revenue, and that there should be a surplus for debt redemption, except in time of war. Now, debt creation as a stimulus to industry is accepted as the latest political fashion. This new principle, which may almost be called another revolution, may be quite right, but it is not likely to make the market for gilt-edged securities very robust and steadfast, especially when this market is also subject to the monetary shocks such as have lately been inflicted on it by the strange movements in gold and foreign exchanges produced by the queer financial policies followed by the central banks of America, France, and Germany. Which also will have to wait for a later chapter.

From all which it follows that though the old-

fashioned idea of investment in gilt-edged securities may still be right – probably is right up to a certain point and as a nucleus with which every investor should begin – it is not so clearly and convincingly right as it was before the cult of the common stock had come in, and before Governments thought that it is good finance to pledge their credit instead of paying debt off as fast as they can.

Moreover, it has already been shown that a large number of the investors of to-day are new to this business, and most of them, perhaps, approach it in a more venturesome spirit than their forebears. They have seen, from the fall in Home Railway preferences and the doubts cast upon the recent financial policy of some of the Dominions, that it does not follow that a trustee security is necessarily one that its holder can go to sleep on for ten or twenty years. Many of them, now that so many more women are earning their livings, bring to bear on the investment problem that wide-eyed sceptical curiosity that makes women so formidable in the presence of old-fashioned principles that are in need of spring-cleaning. They read financial columns and tips and note the fact that fluctuations give opportunities for gain by those who can anticipate them, and are sometimes apt to forget about the losses inflicted on those who get them wrong. Just as most members of the younger generation to-day mean to get a good deal more fun

out of life than their fathers and mothers – and very wisely too, if they can manage it – so the average investor now wants all that can be got out of his or her securities, as big a return as can be got on the money and appreciation in the capital value. In fact the investor of to-day is what old-fashioned stockbrokers of thirty years ago would have called half a speculator.

So now, perhaps, we are in a position to define this person by saying that an investor is a man or woman who buys and holds securities chiefly with the object of receiving an income from them, but also with the desire, if possible, for a growing income and an increasing capital value; while a speculator we may take to be one who buys securities with the object of selling them as soon as possible at a profit, or (though this is much more rare at least among British speculators) one who sells securities in the hope of buying them back at lower prices.

If this definition of an investor be accepted, then every investor who attempts to invest on his or her own account is facing an enormously difficult task, involving possibilities of error which may be costly if not ruinous. It is this kind of investor who provides the largest part of the harvest for the reapers, who take it year by year, in America, something between £100,000,000 and £200,000,000.

And yet it is the fashion to talk and write as if ordinary individuals, knowing as much about securities as I know about a sewing-machine, ought to

tackle this job for themselves. We are told that every investor ought to be an investigator, and books are written to teach them how to discriminate between securities and how to read balance-sheets, and how to estimate the capacity of directors by watching the careers of all the companies in which they are interested. Certainly it is an excellent thing that as many people as possible should apply intelligence to this subject, which will reward them by being quite as interesting in its way as golf or the movies. But to encourage people who have saved a little money to invest it on their own unaided judgment is to give them unkind advice. Let us examine the sort of investigation in which they would have to indulge if they really set about this task with the same earnest conscientiousness that a sensible man applies to the selection of his car, or a careful woman to the furnishing of her house.

CHAPTER III

THE RIDDLE OF A GOVERNMENT SECURITY

Behind all Securities must be Income – Income behind Government Obligations – A Matter of Guesswork – What one wants to Know – Dr. Patterson's Tests – Difficulty of applying Them – Lack of Information – Misleading Inferences from It – Official Improvidence the Creditor's Security.

THE thing that matters most – one might almost say the only thing that matters – about a security is the income behind it – that is, the fund on which it gives the holders a claim.

With Government and municipal loans this income is the revenue that can be collected in taxes and rates from the dwellers in the borrowing area, or from those outside, in so far as it is possible to 'tax the foreigner.'

With companies it is the net revenue left after meeting, out of the gross profits of the concern, all expenses, such as rates and taxes, wages and salaries, maintenance and depreciation. Out of this net revenue the bondholders or debenture-holders (if any) take the first slice, and, since they are creditors whose interest has to be met unless the enterprise is going bankrupt, their slice is often

regarded as an expense, and taken off before net revenue is arrived at. After them come the preference or preferred stock, or shareholders who are entitled to a usually fixed rate of dividend before the ordinary shareholders get anything. The ordinary shareholders get out of what is left (if anything) as much in dividend as the directors think prudent to divide, though nominally, the decision as to the amount of the dividend lies with the shareholders.

Income is in all cases the fund out of which bondholders and shareholders are paid their interest and dividends and the sinking funds (if any) for the redemption of the bonds and debenture stocks are maintained; and however good and costly be the assets that a company may possess, they are of little avail unless it can so handle them as to earn a net revenue – a fact which will be more apparent when we came to look at a company balance-sheet.

For the moment let us begin with the comparatively simple problem of a Government security, which is simple because few figures are to be had about it, and those few are usually presented in such a form as to be wholly incomprehensible to anyone who has not been specially trained in trying to unravel them.

Even among those specially trained there is always room for plenty of difference of opinion as to what the figures really mean. Our British national accounts are supposed to be a model of

fullness and candour – at least we always say so – but whenever one reads a first Budget speech and then the debate thereon, one is sure to find that the assertion of the Chancellor of the Exchequer concerning, for example, the amount of debt that has been redeemed in the course of the previous year differs by many millions from the opinions of his critics on the Opposition benches.

And these figures, elusive as they are, do not tell us what we really want to know. What interests a creditor who has lent money on the security of a country's taxable capacity is the amount of margin that is behind the revenue collected, and this is and must be a matter of guesswork. We cannot arrive at the margin by working out the proportion between the debt charge and the total revenue, and saying that, because our British debt charge and sinking fund come to £354,000,000 and the total revenue to £826,000,000 odd, therefore there is a margin of more than £470,000,000. For those £470,000,000 are needed for services and purposes which have to be provided, at least in the opinion of those who carry them out and benefit by them. The machinery of government has to work and must have the necessary lubricant pumped into it by the revenue collectors out of the taxpayers' pockets. It is customary, when loans are issued on behalf of nations which do not enjoy quite first-class credit, to arrange that they shall have a first charge on this or that source of the

Government's revenue, such as the Customs duties or a tobacco monopoly. These arrangements are popular with the stock exchanges and with the investing public, and they certainly have some practical value, as has often been shown when debtors have had to compound with their creditors. But, in fact, the first charge on all the revenues of every country must be the amount that it thinks necessary to spend on its own administration and defence. This amount it will spend as long as it can raise it, how tight soever be the financial corner in which it finds itself, and the claims of debt-holders, especially if they are aliens in some far-off country, will come second if the corner be tight enough, in spite of the most careful protection given to the debt-holders by the terms of the bond.

If, then, we want to know what is the margin behind our claim upon a Government for so many millions a year, we can only find the answer by making a guess as to how much the debtor nation would allow itself to be taxed in order to maintain its good faith if misfortune impaired its revenue and increased its expenditure to a point that threatened the service of the debt. And if we want to know how much prospect there is of such misfortunes happening, we should first of all have to find out very carefully what are the chief kinds of business and production from which the inhabitants earn their livings, for this is the source of the

revenue out of which the creditors are paid, and then make intelligent guesses about the prospects of these businesses and industries, and the extent to which they can be trusted to flourish in the future.

When it is a matter of foreign held debt, we have also to try to be sure that the industries of the borrowing country will be able to succeed in competition in the world market, because a nation that owes money to creditors abroad can only pay by selling some of its assets or produce abroad. If Brazil owes money to American bondholders, the Brazilian Government has to find American dollars to meet the debt charge (apart from the most unlikely readiness of the American lenders to take payment in Brazilian milreis). It buys them from the banks and others who deal in foreign currencies – what is called the market in foreign exchange – but it can only do so if someone has dollars to sell in exchange for the milreis in which the Government collects its revenue; and the only way in which Brazilian banks and merchants can acquire dollars for sale is by selling coffee and other Brazilian products to Americans, or to some foreigner whose currency can be turned into dollars. It can, of course, also be done by borrowing, and, in fact, the way in which most debtor countries have hitherto met their debt charges has generally been by taking 'another of the same' from the lender, or from some other lender. But this is not paying.

When it is really a matter of paying to a foreign creditor in his own money, a debtor, whether a Government or a company or a private trader, must obviously be able to get a supply of the creditor's money.

At present all the world owes money to America and so has to find dollars. Finding dollars by sending goods to America is difficult because of the stiff duties imposed by the American tariff. So the problem is partly postponed by more loans from America to its debtors, and otherwise is solved by the different countries sending it rubber, tea, coffee, and some of the other things (they are very few) which it does not produce and consequently tax on entry, or sending gold out of the vaults of the central banks to be added to America's already huge store, or by carrying American goods across the sea, or by selling goods and steamer and railway tickets and hotel accommodation to the American tourists who swarm all over the world, or antiques to American collectors, and so on – it would take a volume to describe all the details and ramifications of international trade. All that need be made clear here is, that a country with a foreign debt must be able to sell something abroad, or to visiting foreigners, and that the capacity of the debtor to do so is one of the things that has to be considered when we are trying to arrive at the value of a Government bond.

Other tests that have to be applied have been

scientifically classified by Dr. E. M. Patterson, Professor of Economics in the University of Pennsylvania, who has written a book entitled *Tests of a Foreign Government Bond*.[1] He sets them out as follows: –

(1) The borrowing country and its people should have a long record of good faith toward their creditors.

(2) The general economic status of the borrowing country should be one of continuing and healthily expanding prosperity.

(3) The budget of the borrowing Government should be clearly and definitely in balance, and a sinking fund should be provided.

(4) The debt charges on the unproductive debt of the Government should be no more than from 10 per cent. to 30 per cent. of the national income.

(5) On balance, the borrowing country's international payments should be favourable or at least potentially favourable.

(6) Funds secured from the bond issue should be used productively.

(7) The Government of the borrowing country should be stable, and the political trend should not be extremely reactionary nor strongly radical.

[1] Published by Payson & Clark, New York.

(8) The bonds should be promises to pay in gold (or its equivalent).

(9) The bonds should be completely tax free in the issuing country.

A very excellent list, we shall all agree; but how is the private investor going to try to apply them, or how could even the most expert accountant or statistical sleuth find the answer to some of them? Book-keeping ingenuity can do miracles with figures, as will be shown when we come to look at company accounts, and the difficulty of interpreting those of the British Government, as elucidated by the Chancellor of the Exchequer and then obfuscated by his critics, has already been mentioned. It was reported in *The Times* of 10th August 1929 that a statement may shortly be expected from the American Government concerning the foreign loan policy of the United States, which will be unfavourable to the resort to the American money market of countries which do not balance their Budgets. Unless the State department lays down very precise rules as to what balancing a Budget means, the result of such a regulation may merely mean that Governments will be encouraged to perform an old-fashioned book-keeping trick and provide, out of capital account,[1] things that ought to be met out of revenue, so producing, on paper, a nice clean-looking Budget.

[1] Explained later on p. 46.

As to test No. 2, let us cite the opinion of Dr. Patterson himself as to the difficulties that bristle round about it.

> 'The economic status,' he writes (p. 28), 'of a country might be determined in much the same way as that of a corporation.[1] A statement of assets and of liabilities, *i.e.* a balance-sheet for a series of dates – and a statement of receipts and expenditures, *i.e.* an income account – for a period of years would prove as enlightening to the investor in Government obligations as is such information to the buyer of corporate securities. Unfortunately, so complete a picture can hardly be obtained. Credit men know the intricacies of private finance, and can testify to the obstacles that are encountered in trying to determine whether a single individual or corporation should receive a loan. For an entire country the task of compiling similar data is overwhelming. Information is difficult both to secure and to interpret, and no great amount of accuracy is possible.'

So the Professor gives us certain indices to be studied as keys to the economic position of a country, such as volume of currency, price movements, foreign exchanges, interest rates, bank reserves, etc., though he admits that 'the prospective investor will have, generally, neither the time

[1] In America a corporation generally means what we call a company in England. In England it usually means a municipality.

nor the sources of information to permit of such comprehensive study.' But surely we may go much further and say that, even if he had the necessary time, information, and enthusiasm for plunging into statistics of this kind, he would be more than likely, unless he had had years of training at the job, to flounder up to his chin in errors and false inferences. Some of us can still remember being warned by one of the Dominion premiers – a statesman who had come to a Colonial Conference with a great reputation from Australasia – that England had to pay year by year in golden sovereigns, which were then her currency, for what is called her adverse balance of trade – the sum by which her commodity imports exceeded her commodity exports. In fact, she was not only paying for them by her 'invisible' exports of shipping services, etc., but was providing a handsome balance to be added to her capital already invested abroad. And whence were these 150,000,000 or so of sovereigns to be produced by a country which boasts no gold reefs? This incident is rich in light on the minds of statesmen, and also on the errors which may proceed from statistical study, when statistics are to be had, by those who do not study them quite enough. But, as a rule, there are no figures to be found – 'for only in a few countries have the statisticians attempted even roughly to determine wealth and income,' and nothing but a rough attempt is at any time possible, as life is now

organized, unless we are to set half the population to work to measure and value the activities and possessions of the other half.

And so, as was said at the outset, a Government bond is a comparatively simple matter to test, to those who are in the security-testing business. A stockbroker who was asked what he thought of Argentine bonds would probably say that they were not 'gilt-edged,' but quite all right as part of a varied menu. He would have a hazy recollection that something had happened about Argentina some forty years ago and he would feel, or think, that South American politics are never really secure and settled; but he would know that the country had met its obligations punctually as long as he could remember, that it is rich in grain and beeves, and is a quite trustworthy debtor, as debtors go. He would also know – and this is a point to which he would rightly attach much importance – that Argentine loans have been handled in London by a highly distinguished issuing house which could be relied on, if anything went wrong, to spend, in the interests of its own prestige, unlimited time and energy in the protection of the bondholders; and he would know that 'the market thinks well of Argentines' and that the sentiment of the London market, with its century of experience and deceptions and disillusionments behind it, is quite a helpful guide.

Dr. Patterson, in the illuminating passage quoted above, pointed out how hard it is to decide whether

an individual or a company should have a loan, and how much harder it is to get trustworthy data about a Government; and we have seen by what rough and ready rule-of-thumb reasoning the City arrives at its estimates of the credit of governmental borrowers. But there is one point that is always on the side of the creditor in dealing with a Government, and that is the incurable tendency of Governments to outrun the constable and so to want to borrow some more. As long as nearly all Governments are likely to want to borrow, they will do their utmost to avoid repudiation.

But as to the relative merit of the bonds of one Government or another, we can only make guesses from what we know, or think we know, about the character and history and prospects of the people behind the Governments. It was once said of an Oxford economist that his knowledge of the working classes was a series of hasty inferences from his observations of the behaviour of his scout. (A scout at Oxford is a college servant.) This is about as much as the ordinary private investor has to guide him in assessing a Government bond. And does the professional expert know much more?

CHAPTER IV

BALANCE-SHEET MYSTERIES

Why Capital is Needed – The Problem of Capital Account – Book-keeping and Profit – Depreciation – A Specimen Balance-sheet – Liabilities that look like Assets – Assets and their Dubious Value – Deception that is Desirable – Goodwill, most valuable when Lowest Valued – Debtors and Stock-in-Trade – Sir Mark Webster Jenkinson on Balance-sheets – The Best Asset, that never Appears.

BUT it is when we come to company accounts that the bewilderment of the investigating investor really begins, for here he is shown an array of figures presented in a balance-sheet and profit-and-loss account and told that he ought to study them, and detect from what they tell him, whether the company which issues the figures is or is not a concern in which he can place his savings, in the sure hope of an income for the time being, and of getting his money back if ever he wants to sell out.

And yet we shall find, when we look at these figures with that sceptical eye which should be applied to all figures and statements connected with anything that we ever think of buying, that some of the most important figures are sometimes left out – and with good reason for their being so treated – that some of the most impressive of those

that are given are necessarily quite without meaning as a guide to the value of the concern, and that the figures never throw any light on the question which is most important of all, namely, the quality of the management.

All companies work to earn a revenue, and nearly all of them, in order to do so, have to possess premises and own a certain amount of plant and materials. These premises, plant, and materials are what may be called their material assets. They also have to meet certain expenses, incidental to the formation of the company, before they can begin, and if they acquire an existing business they generally have to pay something for the 'goodwill,' the quaint name that covers its connexions, prestige, and earning power.

'Good name in man and woman, dear my lord,
Is the immediate jewel of their souls.'

So says Iago; and goodwill in companies, as we shall see, is a jewel that gives value to all their other assets.

Hence the need for capital, which the public is asked to provide, in exchange for securities, bonds, debentures, preferred shares and ordinary shares, which give it a claim to a share in the income of the concern – a first charge at a fixed rate for holders of bonds and debentures, a fixed rate of dividend, sometimes with a chance of some more when the ordinary shareholders have had a certain rate, for

the preferred or preference holders; and any balance over is the property of the ordinary shareholders, subject to any participating rights to which the preferred may be entitled.

But though the balance left over belongs to the ordinary shareholders, it by no means follows that they receive the whole of it in dividend; in fact it may be said that they never should do so. The directors decide, subject to the usually quite nominal confirmation of the shareholders, how much of the balance shall be paid to them in dividend, and how much shall be ploughed back into the company's field, in the form of addition to reserves, or to the amount carried forward. But these sums that are ploughed in again are still the property of the shareholders, and if they are put to good use in the business, or well invested outside of it, will bring in revenue in future, so tending to increased dividends in years to come and, consequently, a higher market price for the shares.

The company, then, gets its capital from those who subscribe for the securities and invests it in the assets, as described, that are necessary for its working. But this capital account is one of the causes which make company accounts a matter of glorious uncertainty, because all through the company's history it will be buying, especially if it is active and expansive, more things which will be wanted for its future working; and there will always be a number of things on the border line about which

perfectly honest opinion may differ as to whether they should be regarded as new assets and so a charge on capital, or necessary materials to be provided out of revenue. In order to understand the distinction, let us look at the example of an individual worker using his own little capital of £10,000 and so under no necessity of showing accounts to the public. Let us suppose that he keeps a shop and has spent during the past year £1000 on improving the furniture and fittings and the window display. In the meantime he has gone on as usual with his business, earning revenue by selling at retail prices to his customers goods which he had bought from the merchants and brokers on wholesale terms. He wants to know, exactly and precisely, how much revenue or profit he has made from his business. But how much of this expenditure on improvements should he meet out of revenue account, and how much may he regard as capital expenditure, to be added to the amount that he spent on premises, furniture and stock when he started, as the fund sunk in the business? If the business were carried on by a husband and wife, one might imagine them – it is a scene and a problem that would have interested Balzac intensely – differing acutely, one maintaining that the improvement money was fair capital expenditure, sure to increase the revenues of future years, that it had therefore been invested, not spent, and that the family was fully entitled to a new automobile

and the usual seaside holiday; while the other, the financial purist of the party, would argue that the increased revenue from the improvements was only a hope, that capitalizing hopes was always a mistake, that the money should be put down to working expenses reducing the year's profit by so much, and that the new car must wait.

If we draw up a simple balance-sheet of this little family business we can see at a glance the difference that the decision on this point will make.

The new fittings have been paid for and the figures are as follows: –

(A)

Capital . .	£10,000	Premises, furniture, stock, etc. . . .	£10,000
Profit . .	1,000	Cash in hand and at bank . .	1,000
	£11,000		£11,000

If the new furniture is taken as capital expenditure, and is therefore represented as an addition to the assets, then the account will appear thus: –

(B)

Capital . .	£10,000	Premises, furniture, stock, etc. . . .	£11,000
Profit . .	2,000	Cash in hand and at bank . . .	1,000
	£12,000		£12,000

If the purist wins, the figures are as in A and the year's profit is £1000. If otherwise, the profit is doubled, and this simplified example shows us how great a difference may be made to the appearance of the earning power of a business by variations in book-keeping practice.

And when we come to questions like depreciation of buildings, plant, and furniture and the value of the stock of goods on hand, and allowance for bad and doubtful debts, it is easy to imagine Monsieur and Madame César Birotteau differing so widely as to cause serious domestic discord. Was there not a scene in *Potash and Perlmutter* – that cheery pre-War play – in which the two partners disputed whether the motor car owned by the firm was an asset or a liability? No building is going to last for ever, but if it is kept in good repair year by year, is not that enough? No, says the purist, because a change of fashion or a street improvement round the corner may halve the business value of your premises. Plant and furniture, and especially machinery, wear out quickly, and in some trades machinery never gets a chance of wearing out because it is bound to be superseded while still in its prime. That they have to be written down – that is, that sums ought to be set aside out of revenue towards their ultimate replacement – no one can deny; but there is room for immense differences of opinion between Monsieur and Madame as to the amount to be taken off their

book value, and so off the profit balance, for this purpose, and nobody can be certain as to which of them is right. In fact, in a matter involving so much guesswork it is practically impossible that either can be exactly right, and the real question is which of them is erring least and in the right direction. Common sense and experience are strongly on the side of the purist and tell us that those people fare best in the long run who take the austere line about these things, charging revenue, whenever there is a possible excuse, for improvements and renewals – however good the reasons may seem to be for paying for part of them, at least, out of capital account – making lavish provision for depreciation and maintenance, placing a low value on stock-in-trade, or inventories as they are called in America, and taking a careful, even jaundiced, view of the probable solvency of trade debtors.

Such is the policy which makes for success in all kinds of business. The first requisite, as need hardly be said, is good management in the conduct of the enterprise. In our example of a shopkeeper, the first thing needed is that he shall know what goods to buy and how to buy them well, how to put them attractively before his customers, and how to deal with the latter with the punctuality and courtesy and honesty which make for success. But after that what is called the financial policy – the system on which these problems of capital account and

the values placed on assets are dealt with – is of the highest importance. With good technical management and a sound financial policy, any business that is meeting a public need will do well.

How much light will a balance-sheet throw on these two essentials? Let us take a good specimen and consider it. Here is that of the (English) General Electric Company, lately in the limelight owing to extensive American purchases of its shares: –

BALANCE-SHEET AS

Dr.		
Capital issued:		
A. Preference shares:		
1,800,000 £1 shares	£1,800,000	
B. Preference shares:–		
1,800,000 £1 shares	1,800,000	
Ordinary shares:–		
2,253,645 £1 shares	2,253,645	
		£5,853,645
7 per cent. Debenture stock	3,500,000	
Less redeemed	431,940	
		3,068,060
Sundry creditors		2,230,999
Reserve account	1,100,000	
Add transfer from profit-and-loss account	130,000	1,230,000
Profit-and-loss account		587,436
		£12,970,140

This is an exceptionally good and clear balance-sheet issued by an exceptionally prosperous and well-financed company; but how many amateur investors could read its meaning, and how many professional experts could tell us from it what is the real earning power of the concern and what, therefore, is a reasonable price for its shares, apart from problematical prospects and possibilities?

It has been stated by an eminent authority on

AT 31ST MARCH 1929

		Cr.
Freehold and leasehold land and buildings	£3,411,557	
Depreciation for the year	67,579	
		£3,343,978
Fixed plant and machinery	966,761	
Depreciation for the year	100,130	
		866,631
Loose plant, tools, patterns, and sundry utensils	36,652	
Depreciation for the year	36,651	
		1
Fixtures and installations	1,696	
Depreciation for the year	1,695	
		1
Goodwill and patents		1
Sundry debtors, including amount due from subsidiary companies after making provision for doubtful debts		3,466,971
Stock-in-trade and work in progress		2,125,065
Trade and other investments		1,648,487
British Government securities		1,082,709
Cash at bankers and in hand		436,296
		£12,970,140

the subject that the 'balance-sheet, where finally approved by the auditor, should be so clearly stated that every shareholder of ordinary intelligence can understand it,' but the worst of these eminent authorities is that they never can remember that ordinary people are not as clever as they are and have not had their technical training. Most quite intelligent people, faced for the first time by a balance-sheet, find in it a quite incomprehensible cryptogram, and it is only after many explanations and some practice that they can attempt to read any meaning into it.

When it has been explained to them that the *Dr.* in the left-hand corner has nothing to do with a doctor but stands for debtor, and means that the figures on that side represent what are usually called the company's liabilities, they are generally startled and puzzled to find the capital and reserves on this side. For, as they will truly observe, the company's capital and reserves are its property and it has got them; so they ought to be assets – why should one debit oneself with what one possesses?

It is soon made clear that in a sense the capital and reserves are owed by the company to its shareholders; it has received them – the capital from the original subscribers and the reserves out of profits or from premiums on new shares – and so has to account for them, and, in case of liquidation, pay them to the shareholders if they can. But the

fact that some of the entries on the debtor side are not really liabilities at all, in the ordinary sense of the word, remains a cause of confusion and gives a certain aspect of unreality to a balance-sheet.

This unreality is intensified when we cross the page and look at the creditor side, usually called the assets. It has been stated by a learned judge that 'a full and fair balance-sheet must be such a balance-sheet as to convey a truthful statement as to the company's position.' This is a pleasant ideal, but the amazing thing is that authorities do not agree either with one another or, sometimes, even with their own statements on succeeding pages, as to what truth is meant to be conveyed by the figures put down.

With regard to the liabilities there cannot be much doubt. It is so much money received, owed, or to be accounted for. But when we see a figure set against most of the assets in most company balance-sheets one never knows (unless, which is very rare, some definite statement is made on this point) whether this figure means the amount that has been spent on acquiring them, less the amounts that the directors have thought fit to write off them, or whether they are supposed to be an indication of present values on the date of the balance-sheet, and so to be taken as a guide to the value of a share in the company.

The first supposition – that of figures showing

what has been spent – is evidently the most simple and straightforward from the book-keeping point of view, and entirely truthful as far as it goes; but at the same time it does not help us much, if at all, to form an opinion, as investigating investors are so often urged to do, about the position and prospects of the company. For it does not by any means follow that because a certain amount has been spent on a thing that it is worth that sum, or anything like it, or anything at all now; still less does it mean that those who possess it will receive a certain income, or any income at all, and it will be remembered that the income behind a security, to meet the claims for interest or dividend from those who hold it, is by far the most important thing about it from the point of view of the investor.

Looking at these assets one by one, we see freehold and leasehold land and buildings put together in one figure, totalling more than £3,300,000. During the past year £67,000 has been written off the total for depreciation, and from what one knows of the company and its Board one may be sure that this sum is ample. Nevertheless one would also like to know how much of the land is freehold, and how much leasehold, and how much of the total set against this comprehensive item represents buildings, for buildings are in a different class from land. A piece of land is almost always worth something, and the High Priests of the auditing world seem to regard its value as something immutable, telling us that its

original cost, if it be freehold, is the correct sum at which it should stand, though in fact land, as we all know, goes up and down in value, sometimes very fast. But buildings are only valuable for a certain purpose. A factory built to produce an article which is no longer wanted enough to give those who produce it a profit is likely to need to be gutted and reconstructed, if not to be pulled down altogether, and so may be, like Perlmutter's automobile, a liability rather than an asset.

Fixed plant and machinery have been written down by more than 10 per cent., and we may be sure that they are worth to the company a good deal more than the figure at which they stand. But how much more? And if a veracious statement of present values is what we want, what is the use of figures about which, owing to our confidence in the Board which issues them, and the auditors who certify them to be in accordance with the books of the company, we strongly suspect they are too low?

Still deeper is the bewilderment of the inexperienced unraveller of this fascinating puzzle when he proceeds to the next three items, all written down to a pound. Left to himself he might easily conclude that owing to some disaster during the past year all the loose plant, tools, patterns, sundry utensils, fixtures, and installations had fallen from a value of £38,000 odd to £2. In fact, of course, all that has happened is that

the directors, following the conservative lines of purist financial policy, which we have already seen to pay best, have written down the value of these articles to a merely nominal value, thereby strengthening the balance-sheet, but removing it a little further from veracity, which, in balance-sheets, is not nearly as important as strength.

In fact it may almost be said that, as long as the deception is in the right direction, the less veracity there is about the assets in a balance-sheet, the better for the shareholders and everybody else concerned. This disconcerting fact is strikingly exemplified by the valuation of goodwill. In some ways this is the most valuable asset that a trading or producing company can own, for goodwill means connexion and selling power. Without it the most skilfully made article will fail to find a market, and its makers will fail to find a profit. And yet in the most highly respectable balance-sheets, such as those issued by banks and insurance companies, goodwill is not even mentioned. Mr. P. D. Leake, in an interesting little book that he has lately published on *Balance-sheet Values*,[1] says that the exchangeable value of goodwill of all kinds depends upon the probability of earning future super-profit – 'super-profit meaning the amount by which revenue, increase of value, or other advantage received exceeds any and all economic expenditure incidental to its production.' He

[1] Gee & Co.

considers that this super-profit can never be permanent, owing to the competition that success provokes, the probability that the demand for any commodity or service may cease, and the probable deterioration of directing ability.

These risks are certainly inherent in every profit-earning enterprise, and since good finance is a strong shield against them, it is clearly a sound instinct that impels the most prosperous companies, whose goodwill is most valuable, to take no, or a merely nominal, credit for it among their assets. America's practice endorses this principle. As Mr. Rukeyser says: –

> 'Goodwill represents the reputation or standing of the enterprise in the business world, undoubtedly a thing of real worth. However, it is a paradox of business that those concerns with a genuine goodwill, for reasons of conservatism, carry it at little or nothing among their assets, whereas those without real goodwill have an inflated item under that heading on the balance-sheet. Banks which possess a reputation of great value do not carry items of this nature in their statements. Moreover, the Eastman Kodak Co., whose trade name and patents are of colossal value, does not include these items among its assets. The General Electric Company values its numerous and enormously valuable patents and franchises at one dollar.' [1]

[1] *The Common Sense of Money and Investments*, p. 220.

And its English namesake, whose balance-sheet we have before us, puts goodwill and patents at one pound.

And so one of the puzzles to which a student of balance-sheets has to accustom himself is the fact that the lower the value shown of some of the company's most important possessions, the stronger is its true position.

In the 'Sundry debtors' item, standing at nearly £3,500,000, we see that provision for doubtful debts has been applied, and when we have confidence in the Board we may be sure that here also the conservative policy has been adopted, and that this provision has been more than ample. It is in writing down these doubtful items, and putting them in at figures below the sums that they are likely to realize, that the Boards of well-financed companies establish their hidden reserves, enabling them to meet sudden blows from the fist of that capricious jade, Fortune, without disclosing the fact to the shareholders, who might be unduly alarmed, or to customers and Press critics, who might make too much of the matter, or to competitors, who might be enabled to take an inconvenient advantage. And here again the accuracy of the balance-sheet is sacrificed to strength. It will be noted that the amount owed to the company by its debtors is, even after being so written down, nearly £1,250,000 larger than the sum that it owes to its 'Sundry Creditors' among

the liabilities. This is always hailed as a sign of strength, and it is certainly better, if a day of reckoning comes, to have more debts to collect than to pay, as long as the debtors are good. But it is not necessarily a sign of good business to have large sums owing; it may mean that a company has been giving more credit than was wise, and pushing a campaign of cut-throat competition by sales which may some day prove to have been gifts, because the buyers cannot pay.

'Stock-in-trade and work in progress' is another item on which the inquirer has to take somebody's word for the value. Obviously the auditors cannot be expected to value the company's stock of goods on hand and of half-finished articles; and so it is usual to see (as in this case) a statement in the auditors' certificate to the effect that these items have been certified by heads of departments; which, when the company is officered by judicious and honest men, as happens to the great majority, is a sufficient safeguard, and we know that the stock, when it comes to market in due course, will fetch at least as much as, and probably a good deal more than, the figure set against it. But this is a line in a balance-sheet which is full of danger if the management is careless, optimistic, or crooked. Mr. Pixley, in his standard work on the *Duties of Auditors*, tells us that

'the amount to be taken credit for in respect of stock is of supreme importance in many companies, as it is no exaggeration to state that it is frequently possible to double or treble the apparent profit, where the directors and managers together, or even the latter alone, without the knowledge of the former, succeed in deceiving the auditor, and consequently the shareholders.'

Need more be said as to the value of a balance-sheet as a sure guide to the position of a company? Here is an item which has to be taken on the word of the company's officers, and this one line, if tricks are played with it, may make the profit look two or three times as big as it is in fact.

In the last three items we come nearer to solid fact. 'Trade and other investments,' unless they are actually quoted on a public stock exchange, may be valued, to some extent, according to fancy, since they may be claimed to bring trade advantages apart from the actual return from them. But this is a matter on which the auditors can keep an eye; and when we come to British Government securities, we know that here there will be a market price by which their value may be compared with the sum at which they stand. And in 'Cash at bankers and in hand' we have bedrock fact, easily tested by the auditors.

We have seen, then, that the value put on nearly

all the assets is the expression of the opinion and policy of those responsible for the company's management – the directors and managers. And the importance of the view that they take on this point is seen to be enormous when we realize that the difference between the aggregate value of the assets and that of the liabilities constitutes the profit and loss balance. If the assets are under-valued, as they are in most good companies, the profit is made smaller. If short-sighted or dishonest policy rules the valuation of the assets, the profit is over-stated; and the shareholder has nothing but his confidence in the Board – which may be misplaced – to tell him in which direction the picture is distorted. If distortion be in the wrong direction, the consequent deception is almost certainly disastrous in the end. If in the right, by under-statement, it is beneficial. But, in any case, a balance-sheet is a mere mirror of certain opinions, and anyone who goes to it for certainty is more than likely to be misled.

Schemes are periodically produced for balance-sheet reform, and discussions of some system by which company accounts could be brought into closer connexion with veracity are a hardy annual. But actual accuracy would evidently be impossible unless every item were independently valued every year by experts, and then it is more than likely that the experts would be wrong. Pleas for clearer statements showing more items separately have

something to be said for them, but even here we have to be careful not to insist on book-keeping niceties which would be bad for the interests of the shareholders. A company was lately criticized for merging its stock and debtors in one item, but the practice was defended, in this case, by the auditor, Sir William Plender. For a very special reason, namely, that the company had to deal in very restricted markets both in purchasing its principal raw material – gutta-percha – and in selling its products. Its source of supply was so limited that it would be quite possible to form a ring to control the market when it had large contracts in hand, and this had, in fact, been tried in the past; and the company's concealment of the amount of the stock held by it was thus a protection of the shareholders' interests.

If, then, there is thus some justification, at least in some cases, for deliberately darkening the little light that a balance-sheet might throw on a company's position, and if, as this chapter has tried to show, such little light as is given is more than likely to be misleading because the best balance-sheets distort as much in one direction as the worst in another, there is no need for further proof that the ordinary investor who puzzles his head over them does worse than waste his time. To those who know what is behind the figures they may be useful as an indication, if treated with sufficient caution. But even to them they throw no

light on what must always be by far the most important of the company's possessions, namely the qualities and abilities of the men who are managing and controlling it. Given a concern with a first-rate, up-to-date outfit of buildings and plant, and a solid goodwill in the shape of a crowd of customers ready to feed out of its hand, it will nevertheless be true that if the management is slack or stupid, and the Board is careless and short-sighted in the matter of financial policy, profits will dwindle and vanish.

But lest it should be thought that this scepticism is based on the ignorance of a carping outsider, let me end by quoting some observations made by Sir Mark Webster Jenkinson, F.C.A., in the course of a paper read before the Sheffield branches of the Institute of Bankers, the Chartered Institute of Secretaries, the Society of Incorporated Accountants, and the Society of Chartered Accountants on 5th March 1928.[1] Here we have a distinguished accountant talking to the brethren of his craft and to bankers and secretaries – a leading expert to an audience of experts – for whose taste nothing would avail but the pure milk of the word. Let us scoop out some of the cream from the rich and brimming bowl that he sets before them: –

> 'The real value of the fixed assets depends on the earning capacity of the business. . . .

[1] Published by Gee & Co., 1s. 6d. net.

To gauge the earning power of the business it is essential to ascertain *how* the profits have been earned, *where* the profits have been earned, *why* the profits have been earned.

'No balance-sheet will, and no balance-sheet can, afford any reliable guide on these matters. Indeed, backers of horses have better information available than speculators in shares! . . .

'You may teach rationalization of industry, or you may preach nationalization of industry as the solution of our economic problems; you may introduce artificial aids of a temporary nature, such as State-aided finance, tariffs, and subsidies; you may appoint Royal Commissions, Committees, and Trade Federations, but, in the end, the value of a business depends on the men who run it.'

And, finally, Sir Mark, evidently convinced that all great truths should be expressed poetically, concluded his address with the following lines: –

'Though your balance-sheet's a model of what balance-sheets should be,
Typed and ruled with great precision in a type that all can see;
Though the grouping of the assets is commendable and clear,
And the details which are given more than usually appear;

Though investments have been valued at the
sale-price of the day,
And the auditors' certificate shows everything
O.K.,
One asset is omitted – and its worth I want to
know,
That asset is the value of the men who run the
show –

CHAPTER V

PROFIT AND LOSS

The Directors' Report – Really Informing – The Profit Figures – Silence as to Expenses – Reasons for Reticence – What 'Writing Down' Means – Need for Clearer Rules for Arriving at Profit – Change made by the Companies' Act, 1929 – Combinations and Holding Companies – Corresponding Figures Wanted.

BUT, it may be suggested, a balance-sheet taken by itself may be as dim a light on a company's position as was contended in the last chapter, but it is not all the light that is given to those who seek it in company accounts. There is the directors' report and the profit and loss account. And fortunately, for shareholders, this is so.

The directors' report often tells us much. That of the General Electric Company gives us, as do all, a list of the directors, and as to the value of directors, and inferences that may be drawn by an examination of their connexions and careers, a separate chapter looms ahead of us. The report gives a clear summary of the company's achievements in the year covered, showing that the profits came to £1,084,077, a figure which we take with the reservations mentioned in the last chapter as necessary; it makes, with £338,456 brought

forward, £1,422,533. After deducting debenture stock interest (£222,380), depreciation (£206,055), contribution to pension fund (£24,662), preference dividends (£252,000), and £130,000 transferred to reserve account, there remains £587,436, out of which the directors propose to pay a dividend at the rate of 10 per cent. per annum on the ordinary shares, absorbing £225,364, and leaving £362,072 to be carried forward to next year.

The directors then go on to tell the shareholders how their company has fared, saying that they are glad to report another year's satisfactory trading, the profits for the year showing an increase of £26,000. The works have been fully employed, the output has reached a high level, and the volume of orders has been satisfactory. The demand for general electrical commodities has shown a steady expansion, which has to some extent counteracted a tendency towards lower prices. The volume of overseas trade has been well maintained, branches in India and Argentina having again had a successful year, while some improvement is visible in South Africa, though in Australia and China conditions have remained difficult. The growth of the business has called for additional accommodation for both the manufacturing and sales organizations. The liquid resources of the company show some reductions, having declined from £1,780,000 to £1,519,000 (this, if we look back at the balance-sheet, is the

total of the company's cash and British Government securities). The reserve has been strengthened by an allocation of £130,000. The number of the company's employees at 31st March reached 22,237.

It is a very nice and cheering statement to find on one's breakfast-table, and any shareholder who looks through it while he cracks his morning egg may well feel strengthened to face the daily round. If he is arithmetically minded he will calculate that the necessary payments – depreciation, debenture stock interest, preference share dividends, and pension fund (which should, perhaps, be included among them) – come to £705,000, leaving a total of £379,000 out of the year's profit of £1,084,000; and that the dividend paid takes only £225,000, leaving £154,000, of which £130,000 is put to reserve and £24,000 is added to the amount carried forward. In other words, the directors could, if they had divided up to the hilt, have recommended a dividend not of 10, but of 16·8 per cent.; but they have followed the policy that pays so well in good hands, of keeping back a large proportion – 40 per cent. in this case – of the profits and reinvesting them in the business, as additions to reserve fund and carry forward.

But not many shareholders are arithmetically minded to the point required for making this calculation, and, since the amount of income, actual and potential, that is behind the shares is the true

test of their value, and since actual income is the safest ground for making estimates of potential income, it may be suggested that all reports would be made more illuminating if they worked out this sum, and showed the shareholders how much, after making all provisions that the Board thought necessary and advisable, had been earned on the ordinary capital. This system would at least tend to remind shareholders that the old-fashioned practice of looking only at the rate of dividend paid is unscientific and inaccurate, since the rate of dividend earned is much more important, and closer attention to it does sounder justice to those companies that are well financed and make, as in the example of the General Electric Company, handsome allocations to reserve.

And now we come to the profit and loss account, and before we look at it, let us see what, according to accounting authority, it ought to tell us. Turning to Mr. Pixley's *Duties of Auditors* we find that

> 'the revenue account of a trading company usually comprehends the two statements known among accountants as a trading account and a profit and loss account. The former shows the gross profit or the gross loss of the period, being the difference between the amount of stock in hand at the commencement of the period, purchases, wages, and other expenses incidental to production, as against the sales and the stock in hand at the end of the period. The balance

of this account is carried forward to the profit and loss account and is then charged with the general expenses incidental to carrying on the business. The balance, after bringing in those charges, shows the actual or net profit, or the loss, of the period. . . . The best method, therefore, of stating the revenue account or profit and loss account of a trading, manufacturing, or mining company is to divide it into three sections, the first showing the gross profit or loss, the second the net profit or loss (as the case may be) of the period, while in the third should be set forth . . . the balance of this and the previous revenue accounts, income-tax, and the dividends paid to shareholders resulting in an actual surplus or deficiency to date of the transactions of the company.'

In Mr. Pixley's view, then, a profit and loss account should show us: –

(1) the gross profit, arrived at by setting forth the difference between stock in hand at the start, plus purchases, wages, and other expenses incidental to production, and sales during the period, plus stock in hand at the finish;

(2) the net profit, arrived at by setting forth the gross profit and charging it with the general expenses of carrying on the business;

(3) what may be called an appropriation account, showing the balance of net revenue

and the balance brought forward, charged with income-tax and the dividend proposed to be paid.

With this ideal before us, let us look at the profit and loss account of the company, the accounts of which we have taken as a favourable specimen (see pages 72-73).

It will be remembered that Sir Mark Webster Jenkinson, in the course of the incisive remarks on balance-sheets quoted in the last chapter, told us that to gauge the earning power of a business it is essential to ascertain 'how the profits have been earned,' and went on to say that no balance-sheet will or can afford any reliable guide on this matter. Unfortunately he did not think it necessary to deal in any detail with the question of the profit and loss account, merely saying that 'if a profit and loss account be attached, such document affords no details of how the profit has been ascertained, or how it has been earned,' and leaving it there as if there were no more to be said about it.

The account that is before us supports this principle. It tells us nothing about the cost of purchases or the sum paid in wages or other expenses of production, or about the salaries of officials, directors' fees, outlay on advertising or other trade expenses. Such reticence in profit and loss accounts is not universal, as seems to be implied by Sir Mark. One sometimes finds one which goes

PROFIT AND LOSS ACCOUNT FOR THE

Dr.			
To Debenture stock interest		£222,380	
Depreciation		206,055	
			£428,435
Balance carried down			994,098
			£1,422,533
To Contribution to pension fund			£24,662
Dividend on A preference shares			117,000
Dividend on B preference shares			135,000
Transfer to reserve account			130,000
			£406,662
To Balance carried to balance-sheet:–			
Proposed dividend on ordinary shares at the rate of 10 per cent. per annum	£225,364		
To be carried forward	362,072		
			587,436
			£994,098

through the form of entering on the credit side the gross profit on trading plus the interest and transfer fees, and setting out opposite thereto the amount paid in salaries, wages, rents, repairs, maintenance, and other expenses, all put together in one comprehensive lump. Some show directors' fees separately. Some veil their amount by including them with auditors' remuneration. But under the new Companies' Act, 1929, the total paid or payable to directors in fees, percentages, or other emoluments, by the company or by subsidiaries, has to be shown separately.

PROFIT AND LOSS

YEAR ENDING 31ST MARCH 1929

		Cr.
By Profit from trading account and income from investments	£1,082,604	
Transfer fees	1,473	
		£1,084,077
Amount brought forward		338,456
		£1,422,533
By balance brought down		£994,098
		£994,098

This is evidently a thing that shareholders are entitled to know, and the publication of it cannot weaken the company's prowess in the race of competition.

Whether much is gained by a display of the gross trading profit, and, opposite to it, of one sum in which all the working expenses are lumped together, may be doubted. And if more detail were required, and the process by which profits had been earned were set out in figures that really threw some light on it, it is safe to expect that very few shareholders would be much the wiser. Financial critics,

and the careful stockbrokers who study company accounts and advise their clients in the light of them, and Trust company managers who bring a trained and scientific mind to bear on them, would have so much more material to work on. But compressed figures are always likely to mislead, and any figures published in a company report must be compressed unless company reports are going to be so vast that they smother information in its sheer mass. And the danger of giving information to competitors is real, for we shall not improve the lot of shareholders if we flood them with figures that they cannot understand, while providing wily rivals of the company with information that helps them to beat it.

There is thus a good deal to be said for the system adopted by the General Electric Company, which simply gives its shareholders very little more than an appropriation account, starting with the amount of the net trading profit and telling us nothing about costs of production and distribution of the goods that it sells. What it does tell us is, what the company has, in the opinion of its directors, endorsed by its auditors, earned. The extent to which the earnings of a company may be varied by opinion and policy, with regard to capital and revenue account and other matters, has already been shown (on p. 47 *seq.*). But this sum of trading profit, given on the faith of an experienced, successful, and trusted Board of directors, is as near as we

can get to knowing what is the earning power of a company in its trading capacity, before the claims of depreciation have been dealt with. Depreciation, and the temper in which it is faced, bring in further causes of differences in opinion and doubt about the accuracy of the final figure of net profit. But when we arrive at this final figure we can at least be sure in a well-financed company that at least this, and probably something more, represents the true earning capacity of the business.

Here, if we have confidence in the Board, we have a definite figure to work on. We can deduct from it the interest and preference dividends (if any) payable, which again are definite figures, and arrive at the rate of dividend earned on the ordinary shares, the true test of their value at the moment, and we can then, by trying to make intelligent guesses about the probable future course of the business, make a shot at what ought to be the price that a prudent buyer will pay for the shares. But to make such shots with any chance of scoring a bull's eye requires a knowledge of trade conditions that is seldom at the disposal of the average ordinary investor; and certainty could only be achieved by those with a complete knowledge of economic conditions all over the world, which have an amazing habit of reacting in unexpected ways on enterprises which were, to all appearance, most serenely immune from outside influences.

Read together with the directors' report, a profit

and loss account, such as that issued by the General Electric Company, is thus shown to give us valuable information, since we have good reason, based on the past performances of the company, to take the Board's statement as to profit earned as understating its true amount. As we do not know the amount of the under-statement we are still faced by some uncertainty, but we have got a more or less definite minimum to stand on. Going back to the details of this account we see that it starts with the amount of the net trading profit, with which it includes income from investments, and charges this amount with debenture stock interest and with depreciation, the sum of which is the total of the amounts shown in the balance-sheet as having been written off land and buildings, plant and machinery, loose plant fixtures, etc. It brings down the balance so produced, and charges it with preference share dividends, contribution to pension fund, and the amount that the Board has decided to place to reserve, and carries the balance to the balance-sheet, indicating that the directors propose to pay out of it a dividend of 10 per cent. (a matter which has to be confirmed by the shareholders' meeting) and to carry the balance forward.

As was shown at the beginning of this chapter, the directors' report gives a summary of the results of the company's work, and adds the important fact that the profits of the year show an increase, of which it states the amount. Most shareholders,

perhaps wisely, pass by the accounts as tending more to headache than to information – 'speaking,' like Gratiano, 'an infinite deal of nothing' – and trust to what the directors tell them in their report and the chairman says at the meeting.

But one of them, fired with a passion for exploring these dark places, has written to me and asked me to explain what is meant by writing down and writing off, where the sums are found which are used for this mysterious purpose, and what becomes of them thereafter; and advised me to put the explanation into the next book I write because he knows many who are puzzled about it.

Sums, then, which are written off a company's assets are taken out of the profits and stay in the business. Writing down or off is simply a book-keeping transaction by which values set on certain items are reduced.

If we look back at the balance-sheet on p. 50, we see that the fixed plant and machinery was written down by £100,000 odd, depreciation for the year. But the company's cash holding was not affected. What was affected was the profit balance on the other side of the account, because if this asset had not been written down the difference between assets and liabilities would have been £100,000 greater, and this difference makes the profit balance. And if none of the other assets had been written down by the amounts shown, the total value set against the assets would have been £206,000 odd higher

than that which is given, and the amount available for dividend would have been, not £587,000, but £793,000. Which only shows, once more, that profit is to some extent a psychological abstraction depending on what, in the opinion of the directors, ought to be written off the book-values of the assets.

In the profit and loss account we see the same process from a different angle. The net trading profit is stated and the amount – £206,000 – of depreciation is deducted therefrom. Nothing happens to the company's cash, which does not appear in this account at all. But in consequence of this allocation to depreciation so much less is deemed to be available for meeting interest, preference dividends, reserve fund, and ordinary dividend.

To financial writers, statisticians, social reformers, and others, to whom the facts and figures of production and consumption are part of their raw material, fuller information from public companies about the process by which they arrive at their profits is an object of chronic craving. And since profit-earning is the basis and incentive of some of the most fruitful of the economic activities of modern communities, it is high time that profit should be, if possible, less of a psychological conception and more of a definitely ascertainable fact. Its accurate measurement is so important to the tax-gatherer, the wage-earner, and

the consumer (if ever this last unfortunate, who is thinking furiously, should find his or her voice) that fuller information seems likely to be demanded, though perhaps only for confidential official use for statistical purposes. It is possible also that accountants will some day lay down definite and publicly stated rules as to the principles on which depreciation should be treated, so that this difficult question need not be complicated as much as it is at present, by variations in opinion and practice.

In the meantime the Companies' Act of 1929 has made certain changes in the matter of the information that has to be given to shareholders, and these changes have been conveniently summarized in a pamphlet by Mr. A. C. Hooper, entitled *Auditors and the Companies' Act*, 1929.'[1] It tells us that a profit and loss account and balance-sheet must now be placed before every company in general meeting, that every member of a public company entitled to vote must have the balance-sheet (though not necessarily the profit and loss account) sent to him, and that every debenture-holder or member of a company not entitled to vote must be given a free copy of the balance-sheet on demand. Moreover, in future a balance-sheet will have to show 'the general nature of the company's assets, distinguishing between fixed and floating assets and stating how the values of the fixed assets are arrived at'; it will also have

[1] Gee & Co., 1s. 6d. net.

to show, separately, any preliminary expenses or expenses of capital issues that have not been written off, the value, if ascertainable, at which goodwill, patents, and trade mark stand in the books, the aggregate sum at which shares in subsidiary companies or debts due from subsidiaries stand, the debts due to subsidiaries, and how the profits or losses of subsidiaries have been dealt with.

All this helps especially in elucidating the position of the combinations and holding companies which are now, and promise to be more and more, so prominent a feature of our economic system. Their balance-sheets, showing assets that consist largely of shares in subsidiary concerns, are an even more baffling puzzle than that of a company which is the direct owner of the property which is used in production. And the tendency of modern joint-stock finance to form companies to hold the securities of companies which hold the securities of other companies piles up a pyramid of claims to claims upon claims under which the real force which is producing the income on which they all ultimately have to live is buried in a maze of obscurity. Moreover, this piling up of securities on securities gives too easy opportunities for manipulation of markets. Hence it seems likely that the public will, sooner or later, demand a full statement from all companies of all securities held, and of all advances made to other companies.

As to the profit and loss account, we have seen that directors' fees and other emoluments have now to be stated separately. Further elucidation of this account was, apparently, thought to be unnecessary by the committee which devised the Act, but at least it has insisted on its production.

One very obvious reform, which would have made both balance-sheets and profit and loss accounts much more informing to shareholders and everybody else, was, presumably, too simple to suggest itself to the legislating intelligence. As it is, company accounts mean even less than they might, because the balance-sheet gives us the position (or a shadowy sketch of it) at a certain date, and the profit and loss account shows us the profit (more or less) earned during a certain period. They are like a barometer which has not been set. We see the needle standing at a figure, but we do not know whether it has gone up or down, and until we know this it tells us almost nothing. What everybody wants to know is, how the balance-sheet position and the profit and loss record compare with those shown by their predecessors, and that might easily be done if the corresponding figures from the previous statements were always shown.

It is easy to answer that shareholders can keep the old reports and make the comparison for themselves, but most of us untidy folk who are apt to be smothered in a mass of documents in, on, and around our writing-tables prefer to get quit at once

of all papers that we are not obliged to keep; and even the methodical souls who love to file things and docket them and put them away in the right place would find the business of comparison much easier if the figures were printed for them side by side on all the accounts that they are expected to study. This is a simple reform that companies might easily carry out for themselves without waiting to be told to do so. I believe that it would help puzzled shareholders a good deal more than many regulations as to separation of assets.

CHAPTER VI

CONFIDENCE IN THE BOARD

Directors and their Duties – Easy when Management is Successful – Otherwise, Difficult and Anxious – The Drawback of Amateurishness – Directors and Accounts – Elimination of the Unfit by Amalgamation and Rationalization.

It is related of King George the Third that being shown a list of generals who were about to command his armies in the field, he observed, 'I hope these names will terrify the enemy as much as they frighten me.' If investors could, as they are often advised to do, find out all about the gentlemen who adorn the Boards of the companies in which they are proposing to take an interest, it is possible that they might sometimes be saved from an unfortunate purchase. But it is evidently most unlikely that an investing amateur should be able to furnish himself with information of this kind; and the system that he is sometimes advised to try, of looking them up in the *Directory of Directors* and then studying the careers of all the companies that they direct, might work very well if judiciously employed; but might also lead to serious misapprehension if a quite blameless person had

happened to be unlucky in his experience as a director. For the longer one lives in the world of companies and stock markets and business in general, the more clearly one sees that it is very like a game of amateur billiards – that fortunate flukes are the foundation of many a brilliant break, and that a good player, if the luck is against him, will not score nearly as fast as some cheery beginner who plays each stroke without thinking about what is going to happen next.

Moreover, the best directors are not likely to be those comets who have a long string of companies for a tail behind them. As a general rule they are quiet, obscure people who understand some particular line of business and stick to it. Directors and their position and their fees are in many ways an anomaly in our joint-stock system. The rate of pay that is usually granted to them is such that anyone whose time has any value cannot afford to devote much of it to any one company. This clearly indicates that constant attention to the affairs of a company is not expected from them – that they are, as a general rule, just a committee of the shareholders whose business it is to receive periodical reports at Board meetings of the progress of the company's affairs, to give a free hand to the executive officers as long as progress is satisfactory, to replace them with more efficient managers if progress is backward, and to decide questions of policy such as the sums to be spent on advertising

and the prices to be charged for the company's product, and the highly important question of the division of profits – the amounts to be set aside for depreciation and provision for bad debts, and the proportion which, after all claims under these heads have been met, should be put to reserve or added to carry-forward, leaving the balance to be distributed in dividend.

Even in deciding some of these matters the directors will naturally be guided largely by the advice of the executive officers, if these are efficient and producing satisfactory results. On such questions as advertising and price the sales manager and the accounting staff will have much to say and will generally have the last word. The Board's real responsibility, in companies that are faring well, is confined to the financial decision as to the distribution of profits. This is a very heavy responsibility, and it has been shown in previous chapters how much difference it will make to a company's accounts if a strictly austere policy is adopted in this respect, if everything that can be written down is reduced in value and if allocations to reserve are handsome. In this policy directors are almost always supported by the shareholders, who are much less stupid and greedy than is often asserted. The notion that they are like Oliver Twist, and will always ask for more in dividends unless profits are hidden away as much as possible, is largely a libel on the modern shareholder.

When all goes well, the office of director is thus easy and pleasant, but when it is otherwise and the management, owing to bad luck or inefficiency, is not producing good results, his position is extremely difficult and anxious. For then it is the business of the Board to decide whether the bad results are the fault of the management, and if they think that it is so, to improve the management, which may be and probably is an uncomfortably baffling problem, especially if the existing management, as is likely, is convinced that it is in no way responsible for the company's misfortunes. On these occasions a quality is demanded from the Board which is the secret of greatness in so many departments of human activity, namely the power of finding the right man to do a job.

For this purpose a knowledge of the business and of the people connected with it is a great help; and the lack of it, owing to the amateurishness of many directors, is against them when the clouds of disappointment thicken. When I was asked to join the Board of a safety glass company which was then being formed, my natural reply was that I did not see what use I could be to the company, because I did not know anything about making glass. I was told that it is not the business of the Board to do the manufacturing, and I should be useful on the financial side. So, thinking that an inside experience would be a useful addition to my education (which it was) and having satisfied myself, as well

as I could, that the public was going to be given a fair run for its money, and knowing that good and cheap safety glass would be a public boon, I undertook a job that has so far been fruitful chiefly in anxiety. My first instinct was right. Directors who are supposed to have financial experience may be useful on the Boards of well-established businesses, but they cannot, unless they are gifted with other qualities, help a company through its early struggles towards productive efficiency.

> 'On the practical side, every director should be able to appreciate the general principles of joint-stock finance, he should know how to control the working capital of his company, understand the organization of its staff, be in a position to offer constructive criticism on finance and policy, and be able to preserve a spirit of independence and a power of judging for himself. He should understand the principles of costing, taxation, and organization, he must be acquainted with accounting principles, and be able to read a balance-sheet, grasp the import of periodical returns, and know to whom he must turn for information on any point affecting the welfare of the concern whose destiny is committed to his charge.'

Such is the ideal sketched by Messrs. Colesworthy and Morris in their book entitled *Practical Directorship: A Guide to the Duties of a Company*

Director.[1] How far many of those whom they instruct are from reaching it, they show on a later page, when they say :—

> 'It is a remarkable fact that many directors regard balance-sheets with dread and find themselves unable to grasp the principles upon which they are compiled. This difficulty . . . disappears if the distinction between a profit and loss account and a balance-sheet can be thoroughly grasped. That the difference is not appreciated is shown from the procedure which follows the presentation of many draft balance-sheets to Boards to-day. Many directors will persist in looking for wages or other revenue items which happen to be under discussion in the balance-sheet, or endeavour to join in a parley on intangible assets with the profit and loss account before them, utterly failing to grasp the points at issue. Such farcical procedure can be obviated only if the director has a clear idea of what a balance-sheet really is, and is able to follow the principles involved when resolutions are passed affecting the company's accounts.'

This picture of directors who have not even mastered the difference between a balance-sheet and a profit and loss account is drawn by two accountants evidently writing of what they have seen in their own experience. If company accounts are so bewildering a mystery to gentlemen who take

[1] Pitman, 7s. 6d. net.

fees for sitting on Boards, is it likely that they can mean much to the average shareholder? And if many directors know as little about accounts as this description indicates, can a study of the names on the Board be of much use to inquiring investors?

But in fact, of course, the great majority of public companies are honestly and shrewdly conducted, and most directors have enough good sense to know that the best thing for a Board to do is to give a free hand to a good manager if they are lucky enough to have got one.

Eager reformers, scandalized by the disclosures of directorial slackness which sometimes happen, when it appears that shareholders have been deceived and swindled under the noses of those who were supposed to protect their interests, call upon Parliament to tighten up the law, so that the directors of any company which has been dishonestly administered may be flung into gaol as felons. But if the law is made so strict that its penalties are a terror even to those who do their duties according to their lights, there is a grave risk that decent folk will be frightened out of the directing business altogether, leaving it to those who think that they are clever enough to drive a coach and six through any law that ever was devised.

As things are moving now, the process of amalgamation and rationalization of industry is rapidly reducing the number of directors whose

power to do useful work is limited, and retaining only those who either have some special knowledge which can help, or who have connexions which can do good service by bringing business and influencing orders. It is these connexions which are the justification of many directors who are thought by outside critics to be ornamental or superfluous. Business moves in mysterious ways in the search for profits, and many a name of which the public has never heard, and to which the shareholders attach no importance, is in fact most efficient as a well-baited hook, catching good fish in unsuspected waters. And here we have yet another reason why the uninstructed amateur should be very careful before he draws inferences, from the list of directors, concerning the probable future of a company.

CHAPTER VII

THE NAUGHTINESS OF SHILLING SHARES

Importance of Denomination – Considerable to Holders of Redeemable Bonds and Debentures—Less so to those of Perpetual Debts and Preferred Shares – Indifferent to Common Shareholders – In their case Denomination likely to Mislead – Hence 'No Par Value' Desirable – Shilling Deferred Shares – Do they Allure the Public? – Championed by Mr. Leake as Sound Finance.

ARE shilling shares wicked? And, if so, is not the habit lately introduced by our American and Canadian cousins, of having no par value at all attached to securities, still more reprehensible?

Concerning the naughtiness of shilling shares, which were so popular in the booming spring of 1928, many sound homilies have been preached in these days of disillusionment. But touching this question of the alleged evils attached to shares with low, or no, values printed on them, we can see light more easily when we have considered what is meant by the value attached to a security. In the case of bonds and debenture stocks, the holding of which makes one not a shareholder but a creditor, the denomination is important and definite if the debt, as most debts are, is redeemable (which

means, not that it may be redeemed, but that it has to be redeemed) at a certain date. Anyone who holds a $5,000 bond of the Pennsylvania Railroad due on 1st May 1943, or at any other date, knows that he will be paid that sum on that day, and in the meantime will receive interest at the agreed rate named in the bond.

When there is no date of redemption, or when the debt is stated to be perpetual, the matter is not so simple. Here, as in the example of the debenture stocks of the British railway companies, all that the debtor contracts to do is to pay the holders a certain rate of interest for all time, and this absence of any date at which the debt has to be paid has a very practical effect on the market price of the security. For, within certain obvious limits, there is neither top nor bottom to the price. Great Western Railway 4 per cent. debenture stock went up to 158¾ in 1897, because there was no date at which its holders were going to be paid off, and so all that those who bought it had to consider was, how much they would pay for a perpetual annuity of four pounds. This same stock has, in the course of 1929, touched 78, having been halved in value in thirty-two years, owing to the rise, roughly from 2½ to 5 per cent., in the rate of interest that can be earned by those who buy gilt-edged securities.

This is the reason why, if the rate of interest is going to fall, as is generally expected, perpetual or long-dated obligations are those which investors

who prefer fixed-interest securities ought to choose. Because there will be no due date at which the holder will have his money thrown back at him, at a time when it will be difficult for him to reinvest, and the capital value of his stock will rise as the current rate of interest falls.

Contrariwise, if the rate of interest continues the advance that it has shown in the last thirty-two years (having been still higher during the time just after the War), a due date will be favourable to those who own the securities to which it is attached, because they will be repaid at a time when good investments are going cheap, and their stocks will be kept from falling far by the fact that they have to be redeemed at par at some certain date.

While we are on the subject of bonds and debenture stocks, a word ought to be said about the 'foreclosure' rights attached to those bonds and debentures which are secured by a mortgage. This right of foreclosure means that the bond or debenture-holders, if their interest is not met, can seize the property covered by the mortgage and either work it or sell it, using the proceeds of the sale to repay the sum lent by them – that is, to pay off their securities at their face value. Any surplus realized, which is called the 'equity,' is the property of the debtor company, and that is why common shares which represent the right to the property and profits of a company, when all prior claims have been met, are now often spoken of as equities.

Holders of bonds and debentures with mortgage rights are thus very closely interested in the real value of the assets on which their securities are secured. If their mortgage rights are to have any practical value it is essential that balance-sheet values shall be a veracious representation not merely of what the property has cost, but of what it would fetch if at any time they had to try to sell it. But even to them, earning power, which we saw to be by far the most important consideration for the ordinary shareholder, is really what gives value to their holding. As Mr. E. L. Smith says, 'a bond secured by a mortgage on a stretch of railway, and representing only 50 per cent. of the cost of the railway under mortgage, will not be a safe investment if the traffic over this particular stretch of trackage yields a net income insufficient to pay the interest charges on the bonds. In a reorganization this stretch of road may be abandoned to its bondholders, who will find themselves in the railroad business upon most unpromising terms';[1] and if they tried to sell their property they would find that the possibility of income from it would be the basis of any bid for it. 'Likewise,' continues Mr. Smith, 'the invention of new and more economical machinery may render the plant of a manufacturing company practically worthless without regard to its original cost or the cost of reproducing it.'[2]

[1] *Common Stocks as Long Term Investments*, pp. 14, 15
[2] *Ibid.*

So here we are back again at income as the decisive factor in the value of property and securities or anything else that we buy in the hope of making or getting a living out of it. The notion that used to be so prevalent among old-fashioned investors that anything described as a bond or debenture was necessarily a safe security was largely based on the idea that there were actual tangible assets at the back of them, to be taken over by the creditors if their interest were not forthcoming, and if any other terms of their contract, such as the setting aside of a sinking fund for the redemption of their securities, were not fulfilled. But they forgot that if the debtor company was not earning enough to fulfil the contract the assets on which they were secured might have little or no value, and might even be a source of expense, because they might have to be cleared out of the way before the site could be put to a new purpose.

Preferred and preference stocks and shares are in a position very similar to that of an 'unsecured' bond or debenture – that is, a bond or debenture which has no mortgage rights. If there are no bonds ahead of them there is no practical difference. They are, as a general rule, perpetual, and can only be redeemed if the issuing company goes into liquidation or is reconstructed. Many modern companies, however, especially in America, have lately issued preferred stocks which can be redeemed at the option of the company, usually

at a price – such as 105 – which gives holders a small capital bonus. But most stocks and shares of this kind give their holders a claim to so much income, before the common stockholders get any dividend, as long as the company is a going concern; and, in the event of liquidation, to priority over the ordinary shareholders, in the final distribution of the proceeds of the assets, up to the face value of the preference shares. They also often have an additional safeguard in the fact that their dividend is 'cumulative,' which means that if it falls into default the arrears have to be made good before dividends can be resumed on the common shares.

They are thus, for investors of a compromising turn of mind, a very convenient form of security, half-way between the bond with its first charge and mortgage rights and the common share with its face held out to the first smacks of misfortune. On the other hand, they suffer from the usual drawbacks of a compromise, being less safe than the charges ahead of them and not, like the common shares, entitling their holders to participation in any growth of income that the company may be able to achieve, except in those comparatively rare cases when they carry, in addition to their preferred right to a fixed dividend, a share in any surplus after the common shares have been paid a certain rate.

For preferred shares, a definite denomination –

£1 or £10 or whatever it may be – seems to be necessitated by the fact that, in the event of liquidation of the company, they are usually entitled to be paid the amount originally subscribed for them on their issue. Nevertheless, preferred shares of no par value have lately been issued on the other side of the Atlantic. This is done, presumably, because liquidation and reconstruction are not regarded as probable incidents in the life of a well-found company, and, as long as they are avoided, a preferred share merely gives its holder the right to so much income. But the attachment of a face value seems to be more businesslike to any shares which carry the right to the repayment of a certain sum, in any event, however remote, and however remote be the probability that, if forced liquidation or reconstruction were necessary, the preferred shareholders would get the pound of flesh to which they are on paper entitled.

It is when we come to the final 'equity,' the share, whatever it be called, that gives its holder a claim to the ultimate surplus, when everybody else has been satisfied, of the profits of the company when it is working, and of its property when it is liquidated, that a par value is misleading and may with advantage, from the point of view of strict veracity, be left out altogether or put at a low figure.

These shares, ordinary or deferred or whatever they may be called, carry a quite indefinite claim.

And so, when we put a label on them by calling them £1 or £10 or $100 shares, because they have originally issued in exchange for a certain sum in money, or for services (alleged or real) in securing the start of the company, or in part payment for the business of a concern which the company acquired when it set out on its career, we may sometimes mislead ignorant investors into a belief that this label confers a certain value on the shares. In fact, misapprehensions of this kind are sometimes found existing in heads which ought to have been better furnished. Many years ago, when it was thought necessary to write off half the face value of the shares in a company which had been unfortunate, making them shares of 10s. instead of £1, there was much resistance and protest on the part of the shareholders, who seemed to think that they were being made poorer because their shares were to be called by a different name. In fact, of course, the change made no difference whatever to the earning power of the company or the value of its property, and only recognized the fact of certain losses which had already been made. But the surprising thing was that a seasoned stockbroker not only championed this resistance, but assured me that the change would make a difference if shareholders wanted to borrow from banks on the security of the shares. He asserted that bankers when advancing against shares attach some importance to their face value. I suggested that what

would concern a banker in these circumstances was not the face value but the market price of the shares, and the freedom with which they could be sold. Because the price at which they could be sold, if necessary, determined the amount that could safely be lent against them, and price was ruled by earnings and prospects, and not by face value, which means nothing in the case of an ordinary share. But these arguments were flouted as theoretical by my stockbroker friend, who told me that I was a dangerous revolutionary. But that happened a long time ago, and when lately, in the course of the Vickers reconstruction, assets standing in the books at £12,500,000 were found to be worthless, and the £1 shares were written down to 6s. 8d., their holders accepted the pruning knife without a murmur, recognizing that it was cutting away dead wood, and would leave the company in a healthier condition for future growth.

In practical fact, then, it does not seem to matter what denomination is attached to an ordinary share, as long as its holders recognize that any denomination implies nothing as to the real value of the share, which depends on the earning power that is behind it. What does matter is, that when new companies are brought out to work patents and processes which are either still unproved, or have hitherto been not worked on a commercial scale, the shares offered to the public should be so guarded that those who risk their money by providing the

capital should have a first charge on any profits that are earned, and a chance of sharing in any surplus if the possibilities of 'wealth beyond the dreams of avarice,' which new ventures of this kind usually hold out, should happen to be achieved.

These objects were secured by the system which has since been so vigorously criticized, by which, in the spring of 1928, the public were offered participating (generally cumulative) preferred shares of £1, each subscriber for one preferred share having the right to be allotted at par one, or half of one, or two, or some other fixed number of deferred shares of one shilling. The vendors of the patents usually took the greater part of their payment in deferred shares, and as long as the number of deferred shares that they received was not too big, giving them an excessively large mouthful out of the ultimate profits if produced, the subscribing public had as fair a run for its money as it can expect when it puts it into any untried venture. The preferred shares that they received in return for the bulk of the money that they put in gave them the right to the first profits earned, before the vendors got back a penny on the deferred shares in which they had been paid for the right to work the patent, and the deferred shares, which were allotted to the original subscribers to the preferred shares, gave those members of the public who had put down the capital required a chance of handsome profits, if

the company did well. Moreover, the participating rights attached to the preferred shares gave them a further pull at surplus profits, if any.

On paper this new system of capitalization, though suspected, of course, by those to whom all new things are suspect, looked ingenious and likely to give the subscribing public a better chance than if the issues had been made on the old-fashioned lines, half in preference (with no participation rights) and half in ordinary shares, mostly going to the vendors, or some such arrangement. In capitalizing new companies what matters most is that those members of the public who find the money shall get a fair run for it; and as long as this object is gained the names and denominations of the shares are not a matter of great importance.

But arrangements that look quite well on paper often have unfortunate effects; and, as we all remember, the first half of 1928 saw a great creation of new companies of the kind above described, whose shilling deferred shares were rushed up by a public which was then in one of its speculative moods to prices which have proved disastrous to those who paid them, though they gave the original subscribers favourable opportunities for getting their money back with substantial additions. Most of the companies brought out at that time – safety glass, art-silk, films, and so on – have been, so far, very far from fulfilling their prospectus promises, and since then the sentiment

of markets has been changed from rosy optimism to that grim resignation in face of the incomprehensible and inevitable that afflicts them when gold shipments and bank rates become a nuisance. And in the consequent atmosphere of disillusionment much of that outburst of speculation, which has had such unfortunate results for many of those who took part in it, has been attributed to the existence of these shilling deferred shares, the low denomination of which is alleged to have allured the public into gambling.

If this be true, they are certainly a serious evil, for speculation by those who cannot afford to lose has quite tragic effects. And it is certainly true that speculation at that time was more widely spread than ever before; also that in the rubber boom of 1910 the previous widespread outburst, the appearance of the two-shilling share – in the 'twopenny bazaar,' as it was called – was coincident with activity on the part of a public which had not hitherto paid much attention, or money, to the stock markets. Nevertheless I am inclined to doubt whether the low denomination of the shares handled had much to do with the extent of speculative activity. There was no such alluring bait in the Kaffir boom of the 'nineties, when chartered shares went up to £9 on an immense volume of buying based on the twin attractions of speculative profit and empire-building enthusiasm, and when the movement culminated with the introduction of

Barnato Bank shares at £2. When the public is speculatively minded it will speculate whether the nominal value of the shares with which it plays be £1, or 1s., or 1d., and the much greater space and interest given in these days to City matters by the popular Press may easily account for the wider public attention to market movements and the possibilities of making or losing money by them.

In the meantime, while the moralists are damning the shilling share with bell, book, and candle, as a source of temptation to the weaker brethren, high accounting authority comes forward to contend that shares of no or low denomination make for sound finance. Mr. P. D. Leake, Fellow of the Institute of Chartered Accountants, with many learned technical works to his credit, and whose views on the inevitable ultimate disappearance of goodwill have already been quoted, asks 'Why, then, cannot the irredeemable share capital of a joint-stock company be strictly confined in amount to the appropriate values of things which actually exist, plus the required working capital; the rights, or equity, being always represented by shares of "no par value"? These rights are often of enormous value, but there are no logical rules for estimating this constantly changing value, and therefore it should be left to the judgment of the open market.'[1]

He concludes that the ideal form of joint-stock security to be issued in exchange for purchased

[1] *Balance-sheet Values*, p. 40.

goodwill would be no-par-value shares, but since this is impossible under British company law he thinks that shilling deferred shares may conveniently be substituted, 'provided always that such an issue of shilling deferred shares is equitably apportioned between the vendors, who sell the business, and the purchasers, who subscribe the capital required for the material assets, and provided, further, that those who find the money retain the majority of the voting power.' Given these conditions, Mr. Leake considers that 'this method of vesting the benefit of goodwill has much to commend it in the interests of sound finance, for it avoids altogether the undesirable practice of the heavy capitalization of purchased goodwill.' And he ends his observations on this point by saying that 'there is, of course, nothing to prevent the use of penny deferred shares instead of shilling deferred shares.'

So there we are, with the moralist on one side and sound finance (which also is a moralist) on the other. And, after all, questions of share denomination and forms of capitalization are not nearly as important as the technical success of a company, which provides profits out of which original blots on its escutcheon can be wiped out, and a financial policy which will apply the cleaning process. English critics used to question the American system of covering all the real assets of a company with bond issues and leaving nothing but water

behind the common stock. But if the company made good, so did the common stock. How many millions of common stock in the United States Steel Company had nothing but water behind them when it started business? And how many years did it take to squeeze the water out and put real assets and real earning power behind the stock?

CHAPTER VIII

COMMON SHARES FOR SAFETY?

A Revolution in Investment Theory – Common Shares must mean Risk – The Risk attached to Fixed-rate Stocks and Bonds – The Case of Consols – Fixed Money Income and Higher Prices – The Quantity Theory of Money – Common Stocks and Higher Prices – The Beauty of Compromise – With Common Stocks, Diversification Essential – And Knowledge and Vigilance – Mr E. L. Smith's Experiment and Tests – How far Convincing?

Of all the surprises that would amaze an old-fashioned stockbroker of last century who came to life again to-day, nothing would seem to him so topsy-turvy as the theory that safety is to be found for the investor by the purchase of what our American cousins call 'equities' – common or ordinary stocks and shares. Consols at 54, Union Pacific just below 300, ladies' skirts just above the knee, the Bank of England rebuilding its premises and issuing £1 notes, Mr. Sidney Webb in the House of Lords, French francs at 124 to the pound – all these things would leave him gasping, but he would have no breath left to gasp with when he was told that quite serious people have set out to prove that an investor is more secure who faces the risks of industry by holding ordinary shares than

he or she who abides by what used to be called the 'sweet simplicity' of high-grade fixed-interest securities.

Common shares and risk were once thought to be synonymous, and so in fact they are. The common stockholder gets nothing until all other claims have been satisfied, and so if the fortunes of a company come under a cloud, its bond and debenture holders and its preferred stockholders will evidently fare better. All industry and enterprise involves risk, through changes of fashion and other turns of fortune's wheel and new inventions such as that of the motor car and motor lorry and motor bus, with its effect on railway earnings; and our old-fashioned stockbroker would have a great deal to say for himself, before he could be persuaded that common shares are safer than prior charges. 'How can they be?' he would ask. 'The bonds and preferences get the first bite out of the profits and must be safer. You can't get away from it.' In one sense, he would be right, for, as usual, much depends on what one means by safety. If safety of income alone is considered, and income is regarded as so much money, the claim of the 'gilt-edged' security and the industrial prior charge to superior safety cannot be challenged. There are to-day holders of Consols bought over par who proudly point out that through all the years in which they have held them they have had their $2\frac{1}{2}$ per cent. without ever a moment of doubt about getting it,

and will tell you that that is all they want. The fact that if they wanted to sell they would only get about half the sum that the stock cost does not affect them, because they do not mean to want to sell, and the diminished buying power of the money income they regard as the 'act of God and the King's enemies,' an inevitable result of the War.

But this sublime serenity can only be cultivated by those who are very rich and very philosophical, and have not to consider the point of view of heirs and dependents whose circumstances may not be so comfortable. It has already been suggested that safety of capital – the power to get back, by sale of the security, as much as, or if possible more than, was put into it – is a consideration that the modern investor wants to achieve if he can; and the price of British Consols, once looked on by its holders as the safest security in the world, is a melancholy *memento mori* from this point of view.

'That's all very well,' will be the reply of the stockbroking Rip Van Winkle, who has by this time recovered his argumentative wits, 'but Consols were a freak that never can happen again. How our forebears in the last century ever allowed their Governments to perpetrate such a ramp is a thing no fellow can understand. For investors to take a stock which the Government was not bound to redeem at any time, but could redeem if it liked whenever the money market gave it a chance of borrowing more cheaply, was simply madness. Just

think what the insurance companies and the brokers and the underwriters and the Press would say of such a stock if it were offered to-day – it would be hooted out of the City. Investors who confine themselves to well-secured stocks with a fixed rate of interest and definitely redeemable at dates that are not too far off cannot break many bones through loss of capital.'

This is quite true, and there are in fact many investors who now secure for themselves capital appreciation by buying such securities as Canada three per cents. which are quoted to-day (in August 1929) at about 85 and are redeemable at par in 1938. The yield in immediate income to the buyer at this price is meagre – about $3\frac{1}{2}$ per cent. – but he looks forward to a fat capital bonus in a few years' time.

Having thus shown that there is plenty to be said for those 'whose white investments figure innocence,' as Shakespeare says,[1] and for the time-honoured theory of safety in investment through Government and public securities and the prior charges of industry with a fixed rate of interest, let us see what are the claims on which the superiority of 'equities' as a means of investment is argued.

Let us take the biggest fence first, the risk of a lowered income through a lowered buying power

[1] He was actually referring to an archbishop's vestments, but a line from Shakespeare always does us all good.

of money. This question involves us in abstruse matters such as the Quantity Theory of Money, but it has to be faced by anyone who wants to understand fully the problem of making provision for old age and for inheriting dependents.

It was said above that if income is regarded merely as so much money, then the claims of fixed-interest prior charges to greater safety can be made good. But if we want to provide for those who come after us it is not enough to be sure that they will receive a certain sum of money; we want also to secure, if possible, that they will have a certain command of the goods and services that enable them to live in a certain state of comfort. If there is a general rise in the price of everything that money buys, as has happened in the last fifteen years, and was happening, though much more gradually, from 1896 to 1914, holders of fixed rate securities are pinched, because their money incomes, though unaltered in amount, do not go so far.

This is a weakness against which the holders of fixed rate securities cannot protect themselves. Can the holders of common stocks and shares? Their champions say that they can, and they can show good reason for their contention, both in theory and from experience. For when the prices of goods and services are rising, profits are likely to increase. Producers, such as farmers and miners and manufacturers, find that their goods bring

them better prices, while their fixed charges, such as interest, rates and taxes, wages and salaries, either remain unchanged or move up more slowly; merchants and retailers see the stocks of goods that they hold or sell give them a bonus by going up in value on their own account, so to speak, quite apart from any skill exercised by the merchant in getting the right goods and putting them for sale in the right place. And rising prices quicken business, because if buyers think that the rise is going to continue, they make haste to place their contracts for fear that they should have to pay more.

All these things make for rising profits, and since holders of ordinary shares are entitled to the balance of profit when all other claims have been served, rising profits mean larger dividends for them, or larger amounts put to reserves and carry-forward, which should increase profits and dividends in years to come. At a time when a rise in prices is proceeding at a breakneck pace, as happened during and after the War, the profits of industry are on an almost outrageous scale, and we have all of us heard of examples of shopkeepers who made, in those hectic years, fortunes large enough to set them up as heads of county families.

When these things happen, the ordinary shareholder gets his share of the apparently immense prosperity that blind fortune is pouring into the pockets of all who have goods for sale and assets for appreciation. The prosperity is more apparent

than real, because when the shareholders come to spend their bloated profits they find that other people are making bloated profits also, and that they have to pay more for everything that they buy. But at least they are better off than those who stuck to 'safety first' securities with a fixed rate, for the fixed rate means that the money income of these cautious folk is unchanged, but what economists call their 'real' income – their command of the good things that they want to buy – is cut down by the rise in prices.

Since, then, a rise in commodity prices is a contingency that a careful investor has to consider in weighing the advantages of fixed-interest securities, with their first but limited bite out of profits, against those of the more risky common shares, with their theoretically unlimited possibilities of increase in money income, we have to face the problem of the chances of a rise in commodity prices, and so we come to the Quantity Theory of Money.

Simply expressed, this theory tells us that the general level of commodity prices depends on the relation between the production of articles to be bought and sold and the production of money to buy them with. The War gave us an excellent example of the working of the theory. All the warring Governments wanted money to equip and feed the armies and navies and all those who were organizing and working on the equipment.

They did not want to tax their peoples too severely – some of them did not want to impose any extra taxation at all – for fear of making the War unpopular; and so they made use of the wonderful machinery of credit which private enterprise had built up (and about which more will have to be said in a later chapter) to create new money by means of borrowing. The consequence was that there was a great flood of new money at a time when goods were scarcer, because so many producers were at the front or in training, and in keener demand, because millions of people were being better fed, clothed, and generally cared for than ever before. And so with all this new money in people's pockets and banking accounts, and with fewer goods and services to buy, money fetched less, which is another way of saying that prices went up.

The general broad truth of the Quantity Theory was thus clearly shown; but since then recent events have proved that it has to be taken with many grains of caution. In America an immense expansion of credit and money has lately been accompanied by steady, or slightly falling, commodity prices, because much of the new money has been put into the purchase not of what are ordinarily called commodities, but of securities in the stock exchanges and of real property, houses, and land. This does not mean that the theory was wrong, but only that the definition of commodities

was not wide enough. The relation between the quantity of money and the quantity of articles to be bought remains the chief influence on the general level of prices, if we make that general level sufficiently comprehensive.

So when we try to look ahead and see what are the chances that a rise in prices will make ordinary shares preferable to fixed-interest securities, what we are doing is guessing about the possible expansion of money as compared with the possible expansion of the production of articles to be bought with it.

With regard to money, there is at present much apprehension lest the supply of gold should be inadequate for the creation of enough money to support the present level of prices; and economists have told us that unless the world's banking authorities are more successful than they have been in economizing gold, we are faced with a dreary period of falling prices (which would, incidentally, be favourable to holders of fixed-rate securities), and of the trade depression which is generally assumed to follow from falling prices. And, as will be shown when we come to examine the shocks that have lately been inflicted on investors and speculators by monetary movements, the recent action of the world's banking authorities has tended to make gold much scarcer than it need have been; and so we have seen the spread of a sort of sleeping sickness in stock markets, which has been bad for

investors who had to sell, ruinous to speculators who were gambling on margins, bad for trade and enterprise, and expensive to Governments who want cheap money for financing their floating debts, and converting, if possible, their funded debts.

But, as I hope to show later, this recent period has been exceptional, and there ought not to be much reason to fear that this sort of bad management will continue. It is surely absurd to suppose that, at this stage of human enlightenment, progress is going to be checked by lack of money. How easy it was to create too much of it was shown clearly enough in the War period. It ought to be possible to create enough of it without imposing too severe a strain on the brains of the banking authorities, and of the Governments that make the laws under which they work.

If this be so, then we may fairly expect a supply of money which will be at least adequate to maintain the prices of goods, and may perhaps suffice to continue the process of gradual rise which has been in progress since the time (apparently about the middle of the thirteenth century) when the meat of an ox was worth about a farthing a pound, as Thorold Rogers tells us, in his *Six Centuries of Work and Wages*. It has been shown that rising prices are favourable to business, and they also tend to relieve the burden of debt, at the expense of creditors, because the buying power of the money

in which debt is repaid and interest is met declines gradually as prices rise. Consequently business and governmental interests agree in liking them, and may be expected to work to secure them in spite of the prevalent fashion which is now all in favour of 'stabilization,' the ideal which is, perhaps, fairest to all classes.

Against the tendency of business and Governments to encourage rising prices, we must not forget the great possibilities of productive expansion which science and organization put at man's disposal, if only he will get himself sufficiently civilized to leave off quarrelling, check his patriotic prejudices against buying foreign goods, and give production and commerce a free hand to show what it can do. Against which, again, we have to set the present tendency to amalgamation, combination, and rationalization in industry, which seems likely to take care that the consumer will not be pampered with cheap goods.

So, as usual when one tries to peer into the future course of business and prices, one comes to the lame and impotent conclusion that there is a good deal to be said on both sides, or on about a dozen sides, of the problem. In other words, there is so little certainty in the future course of commodity prices that it would be dangerous to lay one's 'bottom dollar' on this account, either on fixed interest securities or on equities. The *via media* of compromise indicates a judicious blend. Shandy-gaff

may be a mixture which spoils two good drinks, but mixture in investment has always been a wise and popular principle, as is shown by the old adage about the eggs and the basket. In fact, we shall see as we go further that to anyone who ventures outside the gilt-edged pale, the more we mix the better, as long as we have good enough eyes to watch all the items in the mixture.

So far, the argument in favour of the old-fashioned preference for fixed-interest first charges has fairly held its own. It has been shown that those who follow it can protect themselves against capital depreciation by sticking to securities with a definite and not too far distant date of redemption, and can secure capital appreciation by buying at a discount (as in the example given of a Canadian Government loan) stock which is due to be redeemed at par, though this process involves sacrifice of immediate income, and securities of this kind take a good deal of looking for. And on the score of a possible rise or fall in commodity prices, there is so much to be said on both sides that we decided to sit on the fence with a compromise and a mixture. But the champions of the common stock think that they have proved that their system is so safe and certain that it is demonstrably better.

With it, mixture goes without saying. Since risk is inevitable in all industry, and the ordinary share takes the first smack of risk and the last slice of

profit when all others have been helped, no one who wants an income that he can sleep on from his investments would put his all into one. A diversified list of holdings is thus essential, and this fact at the outset makes the system more complicated and troublesome to folk who are not accustomed to considering the merits of securities. It is not only more troublesome and more exacting in its demands on the skill of the selecting investor or his professional adviser at the outset, but it requires much more vigilance and attention and care. Those who are content with the modest yield of the best Government securities can put all that they have into them and forget them, knowing that at least the interest is safe and the capital fairly safe, if the date of redemption is not too remote. But the holder of ten or a dozen common stocks, which is the merest minimum required for safety, must

'grunt and sweat under a weary life'

with a constant eye on all the slings and arrows of outrageous fortune that may affect the welfare of the companies in which he is interested, scanning crop reports, business indices, market reports, and financial papers, and listening to gossip and trying to sift the wheat of it from the chaff, and generally converting himself into a walking example of an ideal stockbroker or investment expert. How many of us have time – to say nothing of other necessary qualifications – to do all these things?

That the cult of the common stock is not suitable for the man in the street is admitted by its champions. Mr. E. L. Smith, whose book on *Common Stocks as Long Term Investments*[1] is, at least in England, its best-known exponent, ends his work with a chapter on Investment Management. He thinks that sound investment management, while always subject to error, cannot fail to improve average investment results if the principle of diversification is strictly adhered to, and gives a list of the principal functions that it has to perform. These include a study of the current conditions of the various industries and groups of industries, an examination of the management and financial structure of the leading companies in these industries, a constant watch on the changes both in the conditions of industries and of individual corporations, and readiness to change the investment to accord with sound analysis of the latest available information.

This, as Mr. Smith very truly observes, is no simple task. In his opinion, with which we shall all agree, it 'can be properly undertaken only by an organization in which men of varied experience and training in the financial field unite with the single purpose of applying their best combined judgment continuously, with the least managerial complications, to the supervision of a single investment fund in which a large number of individual

[1] Published by Macmillan, New York.

investors may participate. Thus, alone, may the best results be obtained.'

In other words, he tells those who want to cultivate the art of investment as elucidated in his book that the safest way for them to do so is through organizations such as the Investment Trust companies, which have been so successful in Great Britain since they came through their period of infant ailments in the early 'nineties of last century, and have lately been multiplied at a pace which some steady-going folk think dangerous. As to them, much will have to be said later. At present let us look at Mr. Smith's elucidation of the merits of common stocks as long-term investments.

His book is all the more beguiling because, as he tells us in his introduction, he began his studies with a failure – the failure of facts to sustain a preconceived theory. Instead of twisting his facts round, or turning them upside down as so many of us are tempted to do when they behave in this awkward fashion, he abandoned his theory and decided to turn the facts loose and follow them to whatever end they might lead.

His theory was that while a diversity of common stocks was undoubtedly a more profitable investment than high-grade bonds in the period from 1897 to 1923, during which dollars were depreciating (*i.e.* prices of commodities were rising), yet with the upturn of the dollar bonds might be expected to show better results than common

stocks – as they did, according to his assumption, from the end of the Civil War to 1896, during which time the purchasing power of the dollar was constantly increasing.

The reasons have already been given on pp. 110 and 111 which tend to produce prosperity for shareholders in times of rising prices, and they might have been expected to work in the opposite way, as Mr. Smith supposed, when the dollar was recovering its purchasing power by the fall in commodity prices in the after-Civil War period. But the tests that he made of the comparative investment value of bonds (which, of course, are fixed-rate prior charge securities) and of common stocks, during the period from 1866 to the end of the last century, showed that this expectation was not sustained by the facts as demonstrated. So he abandoned his conclusion and made more tests extending over the War period and nearly up to the time when he wrote in 1924; and he believes himself to have established, by these investigations, that a well-diversified investment in common stocks, held over a long period, may be counted on not only for a somewhat more than normal income return (compared with current interest rates), but also for a definite increase in principal value, and that this increase in principal value is based, not upon speculative factors, but upon factors inherent in the nature of the security.

Anyone interested in scientific investment will

be well advised to study Mr. Smith's tests, and his account of their selection and results, in his own lively pages. Out of twelve tests taken, over periods never less than seventeen years or more than twenty-two, all except one showed an advantage on the side of common stocks as compared with bonds, and even in the case of the one exception, the income from the stocks had been larger, but there had been greater capital appreciation on the bonds, turning the final balance in their favour.

The tests were applied by seeing what would have happened to an investor who divided a sum of $10,000 among ten common stocks as compared with the results that would have followed the investment of the same amount in high-grade bonds. The total income from each class of security, and the increase or decrease in capital value at the end of the period, are put together and the totals compared. Since it would have been almost impossible, if the investor had been supposed to choose his stocks by intelligent investigation, to have avoided crediting him with some of the knowledge that subsequent history has supplied about them, some quite mechanical principle had to be adopted in selection, as when in Test No. 1 he took the ten industrial common stocks in which there had been the largest number of transactions in the week ending on 12th January 1901, or, in Test No. 2, the ten stocks showing the highest yield on the purchase price.

That the results of these tests is a surprise, and goes far to show that a holding of common stocks is a much less speculative proceeding than used to be supposed, must be acknowledged by anyone who studies them with an open mind. Nevertheless when one looks into them more closely, they are less convincing than when viewed in the broad. Out of the twelve tests only three cover the period of falling commodity prices that ended in 1896; and out of those three, one, as already noted, showed a small advantage in favour of a holding of bonds. Of the rest, no less than eight cover the War period, in which not only were commodity prices rising rapidly, but the United States – and all these tests are concerned with American companies – were making exceptional profits at the expense of the European belligerent Powers and of the neutrals who were cut off from their usual sources of supply of many commodities. And even so, the cash income received by the holder of the common stocks often varied so widely that its owner, if his whole fortune, instead of $10,000, had been at stake, must have led a somewhat anxious life.

In Test No. 2, from 1901 to 1922, the income began at $607 for 1901, touched $1072 for 1906, came back to $657 for 1914 and 1915, shot up to $1097 for 1916, and came down again gradually, closing the period at $673 for 1922, not much higher than it was at the beginning of the experiment.

To the ordinary human being it would be a sore temptation to expand expenditure in the fat years in the hope that they would continue, and then he would find himself pinched when the lean years followed. Mr. Smith, indeed, counsels those who follow the common stock plan to set aside and reinvest any surplus of income from them, as compared with that from bonds, as a reserve against the risk of holding them. But how many of us could be trusted to follow this pious ideal, when there was money at the bank, and the countless reasons in favour of spending it were clamouring for a hearing?

In Test No. 5, from 1866 to 1885 – one of the periods in which commodity prices were falling – the income from stocks began at $1093 for 1866 and rose to $1106 for 1867 – over 11 per cent. After that, only in two years, 1869 and 1872, was it above the $1000 mark; for 1884 it was down to $519, less than half the first year's yield, and for the last year of the series, 1885, it was little better at $565.

In No. 6, covering the same period, the income, which began at $908 for 1886, was up to $1154 for 1872, down to $407 for 1876, up to $1136 for 1881, then was halved for 1882 at $540, and dwindled still further in the last three years of the test, ending at $422 for 1885. This period included a terrific panic in 1873, and was, Mr. Smith tells us, the worst for common stocks from the point of view of falling

commodity values; and certainly anyone who was bringing up a family with so mercurial an income behind him must have envied the serenity of the bondholder with his fixed and certain revenue, even though over the whole period the income from the common stocks beats the bond interest by a narrow margin.

But though the result of these tests is not, when examined closely, such as to encourage us to go blindly for common stocks as the only wear for a self-respecting investor, they certainly show that they ought to have a place, and an important place, in a scientifically planned collection of securities, and Mr. Smith adds to the valuable information that his tests provide by contributing a still more valuable reason for respecting ordinary shares. This is the fact that, according to the practice aimed at by directors of conservatively managed corporations, they will never distribute all the company's net earnings in dividends, but will turn back a part of the earnings to surplus account (or, as we say on this side, add it to reserve or carry-forward) and invest this increasing surplus in productive operation. 'Such a policy successfully carried out is in fact a practical demonstration of the principle of compound interest.'

Here we have the key to the value of the good ordinary share and its superiority, when really good, to the fixed-interest security. A successful company, putting year by year an adequate

proportion of its profits to reserve, is really not only working for its ordinary shareholders, but also saving for them and increasing their capital. Thus their income tends to grow steadily, while that of the holders of the prior charges, though the security behind them improves, is no more than the interest or dividend to which they are entitled by the terms on which they were issued. But we have always to remember that this conservative financial policy, however strictly carried out, will not save the company from disaster – and will, in fact, soon become impossible to achieve – unless it is accompanied by successful industrial management. Without that, there will be no profits either to divide or to add to reserve.

CHAPTER IX

COMMON STOCKS AND THE CONSEQUENCES

Mr. Raynes's Experiment – British Common Shares *v.* Debentures – Overwhelming Victory of Common Shares – Mr. Raynes's Conclusions – His Period of Experiment Exceptional – Consequences of the Common Share Cult – Depression in Fixed-interest Securities – Dear Money in the United States – Tight Money this Side – The Scramble for Gold – Has the Cult Cured Itself?

MR. SMITH'S investigations, examined in the last chapter, thus leave one in an uncertain frame of mind, except that he has at least convinced us that ordinary shares deserve more respect, as investments, than they used to get. American experience, gained chiefly in a period of immense expansion in population and wealth, and at a time when the quarrels of the Old World were pouring millions of dollars into America's pockets and converting her, almost in the twinkling of an eye, from a debtor country into the creditor of all the world, is hardly a foundation for definite inferences applicable to all times and places. James Russell Lowell built better than he knew when he made Gudrida the seer sing to Biörn that

'Weak was the Old World
Wearily war-fenced;
Out of its ashes
Strong as the morning
Springeth the New.'

But there are still a few sparks left among the ashes of the Old and a similar investigation, applied to England and to world securities in general, was evidently wanted and was soon forthcoming. At a meeting of the Institute of Actuaries, held on 28th November 1927, a paper was read by Mr. H. E. Raynes, a Fellow of the Institute, on 'The Place of Ordinary Stocks and Shares (as distinct from Fixed Interest-bearing Securities) in the Investment of Life Insurance Funds.'[1] Insurance companies are so justly associated in the public mind with solid stability and caution in investment that the reading of such a paper in the venerable hall of Staple Inn, where the Institute holds its meetings, had almost a suggestion of profanity. But the reader of the paper, in its opening sentences, was careful to point out that the good reputation of actuaries 'rests perhaps as much on the caution with which they have administered the investment of life funds as upon their ability to deduce sound premium rates and reserves,' and emphatically denied any intention of setting up principles of investment in

[1] This paper, with a report of the subsequent discussion, was printed in the *Journal of the Institute of Actuaries* for March 1928, and has since been reprinted in pamphlet form.

opposition to those which had been honoured for so many years in the history of life assurance. 'It is,' he added, 'from the angle of security that I have investigated the problem in this paper.' Moreover, as he stated, about 4·3 per cent. of the life funds of British offices was already, when he wrote, invested in ordinary stocks and shares.

He also had made an investigation by comparing results and had selected examples by 'a mechanical process which, while it would shock the susceptibilities of any respectable stockbroker, would meet with the approval of a sound statistician.' He chose various groups of securities, the debentures of which would have figured in the investment list of many insurance companies, and compared the result of an investment in those debentures with that of a similar investment in the ordinary stocks or shares of the same companies.

His groups were

(1) British Railways,
(2) British Electricity and Power Companies,
(3) British Gas Companies,
(4) Iron, Coal, and Steel,
(5) Land, Finance, and Mortgage,
(6) Shipping,
(7) Telegraph,
(8) Financial Trusts,
(9) Textile and Allied Companies.

These groups, with the exception of the textile,

are roughly the classification of the London Official List, and they include the chief British trades and industries and, in the Investment Trust companies and the Land, Finance, and Mortgage concerns, the channel through which England has poured so much capital out all over the world, top-dressing the face of the earth. Banking and Insurance shares were not included, because little capital is invested in them in fixed-rate securities, with which share capital could be compared. This was a pity, because insurance companies are a conspicuous example of the benefits that shareholders (as well as policy holders) derive from the practice of large allocations to reserves. The companies selected in each group were the six British concerns with the largest share capital in the list printed in the *Investor's Monthly Manual* for 31st March 1912, provided only that at that date they were paying dividends on their ordinary capital. This system of selection led to the inclusion of many indifferent companies, but freed the framer of the list from any risk of bias due to knowledge acquired in after years.

Mr. Raynes put £54,000 into each class of security – fixed interest and ordinary – £1000 into the ordinary stock and £1000 into fixed-rate, in each of the six companies of the nine groups. The period taken was from March 1912 to March 1927, a fifteen-year space that covered, as he says, 'the majority of our tribulations.' Issues of bonus shares and the changes involved by railway group-

ings were allowed for. Where a company had no debentures he took preference shares or stock. He set out the income received after deduction of income-tax. This was doubtless the correct course for the purposes of his investigation, but owing to the fluctuations during the period in the rate of the tax, it introduces a slightly confusing element into his tables, though not, of course, interfering in any way with the result shown, since the tax applies to both classes of securities. The apparent fluctuations in the income received from the fixed-interest stocks are doubtless due to the variations in the rate of the tax.

Here is the result: –

Comparison of Return to Investor of £54,000 on 31st March 1912 in Ordinary Stocks or Shares with that of a similar sum invested in the corresponding Debenture issues.

Year	Ordinary Stocks or Shares		Debenture Issues		Combined yield of an equal sum invested in each class
	Income after deduction of Tax	Yield	Income after deduction of Tax	Yield	
	£		£		
1912	2964	5·49	2134	3·95	4·72
1913	3624	6·71	2134	3·95	5·33
1914	2763	5·12	2076	3·84	4·48
1915	2946	5·46	1924	3·56	4·51

Year	Ordinary Stocks or Shares		Debenture Issues		Combined yield of an equal sum invested in each class
	Income after deduction of Tax	Yield	Income after deduction of Tax	Yield	
	£		£		
1916	2842	5·26	1699	3·15	4·20
1917	2954	5·47	1698	3·14	4·30
1918	2890	5·35	1584	2·93	4·14
1919	3389	6·28	1584	2·93	4·60
1920	2994	5·54	1584	2·93	4·24
1921	2891	5·35	1584	2·93	4·14
1922	3493	6·47	1699	3·15	4·81
1923	3731	6·91	1754	3·25	5·08
1924	3817	7·07	1736	3·21	5·14
1925	3483	6·45	1783	3·30	4·88
1926	3531	6·54	1783	3·30	4·92

Mr. Raynes comments as follows: –

'The first point that strikes one is that in no year out of the fifteen has the income from the ordinary stocks fallen as low as that yielded by the fixed-interest bearing ones. The yield on the former has always been in excess of 5 per cent. net upon the original investment, while the debenture net income was under 3 per cent. for four successive years. The difference between the yields starts at $1\frac{1}{2}$ per cent. on the original capital and reaches 3·3 in 1919, and from then onwards it remains well over 3 per cent. in excess. The second point to notice is the general upward trend throughout the period of

the yield on the ordinary stocks. There are naturally considerable fluctuations. Taking 1913, the large income from ordinary shares for that year is chiefly due to one of the shipping companies allotting a sum of cash to shareholders in connection with an alteration of its capital. The sudden changes in the rate of tax are also responsible for fluctuations from year to year.

'While the figures show an indisputable advantage in favour of ordinary stocks for the aggregate investment, this is not always the case in the separate groups. The fixed income was larger for the year 1926 in the case of the railways, for the years 1918–1920 inclusive for the gas companies, for 1921–1923 and 1925 for the iron, coal, and steel group; but these are the only exceptions.

'Owing to the fluctuations from year to year, it is difficult to realize the full significance of the excess income derived from the ordinary stocks above that from the fixed-interest ones, and therefore, to bring out the difference more clearly, I have assumed that at the end of each year the excess income from the ordinary stocks received during the year will be accumulated at a net rate of 4 per cent. compound interest till the end of the period, and added to the value of the ordinary stocks at 31st March 1927. In every group of securities there was a positive sum available, after adjustment had been made for years when the income from ordinary stocks was less than that from the debentures; and in

the aggregate the original £54,000 invested in ordinary stocks had not only yielded an income equivalent to the fixed interest class, but had provided by the excess dividends and interest thereon a sum of £27,662 at the end of the term. Taking the prices current on 31st March 1927, the position was as follows:

Market value of ordinary stocks .	£80,073
Accumulated excess dividends .	27,662
Total fund . . .	£107,735

Market value of the debenture fund, £42,588

'Had two trusts been set up on 31st March 1912, maintaining the original investments derived from the respective sums of £54,000 each, and had a sinking fund been set up for the excess income in the one, 15 years after the fund representing the ordinary stocks would have shown almost 100 per cent. appreciation, and that representing the debenture investments would have shown a depreciation of 21 per cent. The difference between the two funds on 31st March 1927 would have been £65,187.

'It is probable that there are many here who, while they have never made an actual investigation, would have anticipated the results shown in the above table, but there may be with them a lurking suspicion that I have loaded the dice in favour of a desired result by choosing the

dates 1912 and 1927 for a comparison. Had I chosen a period within which the market value of fixed-interest bearing securities was rising, a different result would have been shown. Fortunately for our purpose there is such a period falling within the 15 years. At the 31st March 1921 the market value of the fixed-interest bearing securities comprised in our list was £35,051, as against £42,588 in 1927, an appreciation of over 21 per cent. In 1921 the ordinary stocks had a value of £46,557, as against £80,073 in 1927. Had £100,000 been invested at the former date in each of our classes in proportion to the existing holding, the net income received in successive years, and the value of the funds at the end of the term, would be those shown in the following table: –

	Value at 31st March 1921	Net Income						Value at 31st March 1927
		1921	1922	1923	1924	1925	1926	
	£	£	£	£	£	£	£	£
Ordinary Stocks	100,000	6,210	7,532	8,054	8,244	7,510	7,614	172,000
Fixed-interest Stocks	100,000	4,530	4,859	5,017	4,935	5,095	5,095	121,500

'It was pointed out by a speaker in the course of the discussion that if the results as to income and as to appreciation and depreciation were expressed as percentages per annum on the original cost, they could be more clearly visualised. On that basis, in respect of the 15-year period, the net yield in income per annum from

ordinary shares was at 5·9 per cent., and from debentures 3·3 per cent. The net yield in appreciation per annum of ordinary shares was 3·7 per cent., and of debentures was minus 1·4 per cent., making a total of 9·6 per cent. on the ordinary shares, and leaving a balance of 1·9 per cent. on the fixed-interest securities, showing therefore a 5 to 1 superiority in favour of ordinary shares. The results of the second period (1921–1927) also were more than twice as favourable, the total yields, expressed in a similar manner, being 19·5 per cent. and 8·5 per cent. respectively.'

These figures, especially in view of the width of the net that Mr. Raynes threw in fishing them out, are exceedingly impressive. His own conclusion was that nothing could be more convincing as to the merits of spreading investments over a wide area than a consideration of the actual income earned by his fund of ordinary shares; and he goes a step further and says that 'from the point of view of safety, the figures indicate that a well-spread investment in ordinary shares is a better proposition for the ordinary long-term investor than an investment in the debenture issues of the same group of companies.'

And there is more to be said on that score. For the comparison that we really want is, surely, not between industrial ordinary shares and industrial debentures, but between industrial ordinary shares

(because such shares are only produced by industrial companies) and fixed-rate securities in general – Government obligations and high-grade bonds such as those taken by Mr. Smith. Industrial debentures need very nearly as much care in choosing and watching them as ordinary shares, and the problem that we are trying to solve is, whether it is worth while for the average investor to forsake the perhaps less profitable peace and security and freedom from bother that he can get by cleaving to the gilt-edged group, in order to seek the larger income and capital appreciation that are dangled before him by the champions of the ordinary share. If Mr. Raynes had taken, not industrial debentures, but a selection of the securities such as old-fashioned investors in search of Safety First, Second, Third, and Last would have held – including British Government and municipal stocks and other 'trustee' investments – the result of his investigations would certainly have been a good deal more favourable to the ordinary shares. For the income from the gilt-edged stocks would have been lower than that which was earned by the industrial debentures, and the depreciation in their prices would probably have been more severe, owing to the Gargantuan scale on which British Government securities had been created during the War period.

But here again we are confronted by the fact that the fifteen-year period taken by Mr. Raynes was

one in which ordinary shares would naturally be expected to fare better, as compared with fixed-interest securities. It is true that he extended his investigation to 1927, so that it covered the after-War reaction as well as the War period, when high commodity prices were pouring profits into the pockets of ordinary shareholders; and his tests are thus fuller than those of Mr. Smith, which ended with 1922; and it is also true that in England we had an Excess Profits Duty which, though it started late and had many gaps in its net, taxed the War profiteers to some purpose, and that British railway companies were taken over for the time being as a controlled industry with profits limited to the pre-War scale. But still the period was exceptional and on the whole favourable to the case of the ordinary shareholder, and the impression left by his paper is that it throws a great new light on the investment problem, but that, being based on exceptional conditions, it would be unsafe to take it literally as a guide for normal times. The six-year period, 1921–27, is free from this objection, but it is rather too short to be a trustworthy guide; and its result, though emphatically in favour of the ordinary share, was a less overwhelming victory for it.

Mr. Raynes, however, was able to point to certain tendencies as working in the interests of the ordinary shareholders and as likely to continue to do so. He finds that a great improvement has been made

in the past generation in company finance; and that the high standard set by banks, finance, and insurance companies in the accumulation of reserves and moderation in dividend distribution has now extended to many industrial and commercial companies. 'Except,' he says, 'for the period of frenzied finance in the post-War boom, the financial organization of public companies moves on a higher plane now than it did fifteen or twenty years ago.' And not only on the side of finance is this improvement shown. A continuous process of industrial evolution in the growth of the size of the industrial unit and the interlocking of interests 'tends to remove the former extreme fluctuations among small competing interests by spreading them over a wider area. . . . The ordinary shareholder in a particular company is now more likely to participate only in such fluctuations in his dividends as are due to the vicissitudes of the whole industry and is less dependent upon the blunders or exceptional ability of a personal management.'

When he came to answer the question implied by the title of his paper and tell us what should be the place of ordinary shares in the investment of life insurance funds, Mr. Raynes was not prepared to commit himself to naming the actual proportion that they should cover of the total holding; he said that it must, to be of real benefit, represent a significant fraction of the whole but that ordinary shares certainly cannot altogether take the place of

fixed-interest and redeemable stocks. One reason that he gave for this counsel of caution was that insurance companies must always have part of their funds easily convertible, and that ordinary shares would 'certainly not conform to this condition.' On this point one might, with all deference, beg leave to differ. In the matter of a free market the shares of the leading industrial companies are, in many cases, if not as a general rule, better for those who want to dispose of them than fixed-interest securities, except perhaps a few Government securities or trustee investments of the highest class.

But he also laid stress on the specialized knowledge of industrial conditions 'perhaps to a considerably greater degree than at present obtains among actuaries' that is called for when investments in ordinary shares have to be considered. 'Such discrimination,' he says again, 'calls for more than the usual stockbroker's knowledge: it demands a knowledge of the economic conditions of the various trades and industries of the country.'

And so, when we come to sum up the result of this careful investigation by a high authority in its application to the investment problem of the man in the street, we find, in spite of a question mark which had to be put against the period covered by it, that the case for the inclusion of ordinary shares, laid down by Mr. Smith, has been confirmed by Mr. Raynes, experimenting with different mixtures

in a laboratory with a very different position and atmosphere. But diversification has once more been shown to be essential by the varying results of the different groups tested; and Mr. Raynes has told us that in order to qualify for the selection and management of a collection of ordinary shares, one ought to be gifted with more than the usual stockbroker's knowledge and a specialized knowledge of industrial conditions 'perhaps to a considerably greater degree than at present obtains among actuaries.'

In other words, if the man in the street wants to invest in ordinary shares he must be a capitalist to a sufficient extent to be able to put money into many different ventures, and he must have more knowledge than is now general among selected specialists whose skill in investment is an important part of their professional equipment.

In the meantime this belief in the desirability of common stocks and shares as investments has become widespread, especially in the country of its origin, America, and in a less degree in England and in Europe; and, like most economic developments, it is tending to correct and modify itself by its practical effects. Just as a belief that wheat or cotton is scarce will tend to make anyone who can grow them do so, with the result that an addition to the supply will make them plentiful, so the eager buying of common stocks in America and elsewhere, and the accompanying cloud that has fallen over fixed-interest securities, has put the popular

class up to heights at which they look much less attractive as a purchase, and give happy opportunities to the seeker after bargains in the fixed-interest department, which the buying public looks on for the moment with disfavour. Even in the London market, where the volume of buying in the spring of 1928 was comparatively modest, as measured by American standards, and where we have had a very drastic purge and fall in prices owing to the monetary difficulties of 1929, it is surprising to see, in a September 1929 brokers' list that has just appeared, how many of the leading industrial shares still stand at a level at which they yield a buyer, on the basis of current dividends, less than he could get by a purchase of British Government securities. In 1912, when Mr. Raynes made his imaginary investment in ordinary shares and debenture stocks, the former, as the table given above shows, started with an advantage of more than $1\frac{1}{2}$ per cent. in net yield over the latter. It would be otherwise to-day, and the enterprising investor who wants to make a collection of good ordinary shares would be buying a fancy article high-priced because it is all the rage, instead of being, as it was in 1912 and long after, regarded as not quite respectable because of its speculative flavour.

A new system of valuing ordinary shares has come into fashion. We used to calculate the yield on them according to the dividend paid. Then we

proceeded to the much more scientific and correct system (if we are quite certain that profits have not been overstated) of valuing them, not by the dividend paid, but by the rate of profit earned. If a well-managed company with good prospects earned 10 per cent. on its ordinary shares, but put half its available balance to reserves and only paid 5 per cent. in dividend, it was hardly reasonable to value the shares below par. The shareholder was really getting 10 per cent. (and probably more, since we have seen that the profits of well-financed companies are usually understated), though half his earnings were being saved for him and put back into the business. But from this quite sensible step, another one, which takes valuation into the realm of dreams, was easy – the step which values shares not by what the company is earning, but by what it may be expected, or hoped, to be going to earn some day.

When once we start capitalizing perhapses, fancy roves free, especially in America, where the gifts of fortune, the mistakes and crimes of other nations, the energy and determination of the inhabitants and an unbounded confidence in the future of their country, have combined to create possibilities of unparalleled prosperity.

And so we have witnessed that amazing outburst, which was really much too sustained and determined to be called an outburst, of common-share buying in America, which has had far more serious

consequences than merely that of complicating the difficulties of the investor and speculator. Professor Edie, of the University of Chicago, in a pamphlet entitled *Capital – The Money Market – and Gold*, observes that

> 'the middle and late 1920's offer an unusual capital market for economic analysis. The relatively strong desire to purchase common stocks, as compared with bonds, and the quick growth of brokers' and bankers' loans to enable people to carry stocks, are among the most striking features of the situation. Popular analysis apparently assumes that if the shift from bonds to common stocks had not occurred, the prices of corporate shares would not have risen. A more fundamental analysis would suggest that if public buying had been directed towards bonds rather than towards stocks, the price of bonds would have risen to extraordinary heights and very low bond rates of interest would have prevailed. In brief, the significant factors are not merely the shift in buying fashion from bonds to stocks, but the swollen stream of public buying in the aggregate.'

According, then, to this authority the recent popularity of common stocks has prevented a sensational rise in the prices of fixed-interest securities, owing to the pressure of the demand of the American public for investments. Such a movement would certainly have reflected itself in the

British and European markets and would have, incidentally, enabled Finance Ministers on this side to have lightened our debt burdens by conversions of war debts into loans issued at lower rates of interest.

It would also have meant, since fixed-interest loans are the chief means through which Europe borrows from America, that American capital would have continued to flow towards Europe in an undiminished stream instead of subsiding into a mere trickle,[1] and many of the difficulties which tight money in America have inflicted on Europe would have been avoided or lessened.

For it seems fair to suppose that if the American public's demand had gone into fixed-interest securities instead of into common shares, the Federal Reserve Board would have seen less reason to think that there was any need to check speculation, but might even, perhaps, have been ready to assist the public in making a conservative investment of its money. And so we should have been spared the appearance of sensational rates for call money in Wall Street, ranging up on occasion to 20 per cent. (in March 1929), which have had the effect of sucking in money from all countries which had any to spare and from some which had not, and producing that undignified scramble for gold

[1] In the first nine months of 1929 foreign issues in the United States amounted to $275,000,000 as against $1,312,000,000 in the corresponding period of 1928. *See* the *Economist*, Oct. 5, 1929, quoting the New York *Journal of Commerce*.

among central banks on this side of the world, which has done so much to bring the gold standard and all our monetary system into discredit. This subject, and the confusion and bewilderment that the mysteries of the money market inflict on investors and speculators, needs a chapter to itself. Enough has been said to show how wide and deep are the effects of the shift to common stocks, and how seriously it has affected the problem not only of amateur investors, but of Finance Ministers, governors of the central banks, producers, traders, and merchants, and the people who matter, perhaps, most of all because they are most helpless, namely the general consumers – you and me among them – in their struggle after material comfort.

In considering how long it is likely to last we have to avoid what Lord Rosebery in his *Life of Pitt* calls the 'common and erroneous view that human nature is consistent and coherent. The fact is,' he thinks, 'that congruity is the exception; and that time and circumstances and opportunity paint with heedless hands and garish colours on the canvas of a man's life, so that the result is less frequently a finished picture than a palette of squeezed tints.' Since the movements of security prices ultimately depend on what millions of people, as inconsistent and incoherent as his lordship tells us, think, or can be induced to think that they think, that the securities are worth, or are going to be worth some day, attempts to look ahead

about them are more interesting than trustworthy. But if the 'swollen stream of public buying in the aggregate,' referred to by Professor Edie, can be relied on to continue, and if the high prices to which the shift to common stocks has forced their prices can be expected to check the ardour of their supporters, then a change over to fixed-interest securities, and a cessation or reduction of all the adverse consequences of the shift, may be expected some day. But when the public is engaged in capitalizing perhapses it is hardly possible to name a point at which it will begin to doubt its own imagination. For rising prices tend to encourage a constant stream of fresh buyers who look at the rise and the profits that it brings to those who have backed it, rather than to the prosaic facts of arithmetic.

Paying 8 per cent., or even 5 per cent., for carrying shares which return a yield of less than 2 per cent. in dividend, is a diversion which can only pay those who engage in it as long as the prices of the shares rise fast enough to make it profitable. As soon as the rise ceases, it becomes an expensive amusement, for the shares no longer pay for their keep in the meantime, how rosy soever be the prospects of increased income from them some day.

Postscript. – Between the writing of this chapter and its despatch to the printer, the veracity of its concluding platitudes has been demonstrated by

the collapse in prices in Wall Street, and an enormous volume of selling, especially on 24th and 29th October. Again, and of course, it is the small, weak speculator, working on margin with borrowed money, on whom the worst of the loss has fallen. So far, severe as the fall has been, it has been, at least in the case of securities with real earning power behind them, a comparatively mild recession as compared with the long-drawn rise that had gone before.

To the outside world, the most interesting things about this reaction, apart from its effects on British and European speculators who were still following the movement in Wall Street, are (1) the fact that it does not seem to have been produced or accelerated by dear money, for rates in Wall Street had been comparatively easy for some time before it happened; and (2) the possibility that it may mark the end, for the time being, of the exaggerated cult of the common stock, and may be followed by a revival of the bond market, and the cessation of the bad effects inflicted on the rest of the world by the American public's enthusiasm for equities, and the Federal Reserve Board's efforts to check it. If this enthusiasm should revive, let us hope that the Board will remember that it was not checked by dear money, but just boiled over when it got to the edge of the saucepan.

CHAPTER X

THIS BANK RATE NUISANCE

Money and Markets – What Money Is – Gold and International Payments – The Manufacture of Credit – By Central Banks – By Commercial Banks – Gold and Bank Rates – The Gold Standard – Its Benefits – Its Regular Working in Days Gone By – Depends on Low Rates where Gold is Plentiful – This Law lately Ignored – By America and France – Farcical Consequences – A Gold Scramble – Europe Helping America – Need for Co-operation – Bank of International Settlement – Will it Help?

So far, we have waded up to our chins through the muddy stream of difficulties into which investors and speculators have always had to plunge, swollen by a few new ones created by modern tendencies. We have seen how little we most of us really know about the security that is behind Government and public obligations; and how little can be gleaned from a patient study of company accounts, because so many of the figures in them express opinions which are subject to error and cover misstatements which are none the less misleading for being based on the soundest counsels of good finance; and because the figures cannot tell us anything about 'the value of the men who run the show.' We have seen shares of low denomination denounced as luring the weaker brethren on to speculation, and

at the same time recommended by a distinguished accountant as conducive to good book-keeping. We have recognized the immense importance of a trustworthy Board of directors which will guide the financial policy of a company along the lines of prudence so profitable to those who follow them, and we have also noted how hard it is for an ordinary investor to divide the sheep from the goats in the mixed directing herd. And we have seen that a new theory of investment, which sets common shares, from the point of view of safety of income and principal, above fixed-interest prior charge securities, calls for a high standard of knowledge and intelligence from those who propose to follow it.

And now we have to look into the most tiresome, because the most obscure to most of us, difficulty of all, which overwhelms the speculator and dismays the investor, namely the influence on the prices of securities, and of the price of credit for carrying them, of changes in Bank rate, gold shipments, and other mysterious happenings in the money market.

This is no new problem. 'What is this Bank rate nuisance?' a youthful jobber in the Kaffir market was heard to ask in 1896, when the Bank of England moved its official rate, which had been 'silent as a standing pool' at 2 per cent. for more than two years, to $2\frac{1}{2}$ per cent., and someone suggested that if money was going to be dearer, the progress of the Kaffir boom might be less uniformly trium-

phant. But there are certain new features in the modern money market which make it less than ever easy to know what it is going to do next. Speculators, and investors also (though they are much less seriously hit), who have selected on perfectly sound reasoning a security which merits their attention as under-valued and promising, are disgusted and wrathful when they find that, because gold is moving from somewhere to somewhere else, and money is tighter in the place where the gold has gone from, and threatens to be tighter everywhere, because, as they are told, all the central banks will be putting up rates to protect their gold, a shuddering palsy has fallen on markets, and that prices are shrivelling and withering, without any respect for the intrinsic merits of securities. In this dispiriting atmosphere the speculator who is working for a quick turn has no choice. He or she has to close the commitment and pocket the loss, probably cherishing a sense of grievance and a conviction that there is something wrong with the world's monetary management. The investor who has bought a stock to hold can be much more philosophical; but even the serene individual who thinks only of the income to be got from securities and does not bother about market prices (if any such investors still survive) may feel some annoyance at the thought that rather more income could have been bought, if the investment had been made after, and not before, the monetary pest had set in.

So that in order to see the full extent of the difficulties that face the amateur investor and speculator, a sketchy outline of the money market and its vagaries cannot be avoided. For fuller treatment of the subject I may refer my readers to a revised edition, now in course of publication by Mr. John Murray, of a book of mine called *The Meaning of Money*.

Money then, as we all know, is the stuff that we use in buying and selling. It is made of bits of metal or of pieces of paper – bank notes and cheques – but owing to the force of convention and habit, and other reasons, gold, in coin or metal, is the only kind of money that is certain to be acceptable in international payments.

This is so because an Englishman, for example, who had to pay a debt in America could not expect his creditor to take payment in Bank of England notes or in a cheque drawn on an English bank. John Bull would have to pay Cousin Jonathan in dollars, the lawful money of his country. In normal times John Bull would buy dollars at a price in pounds from the money-changers who are called dealers in exchange; but if there were too many John Bulls wanting dollars at the same time, the price of dollars would go to a premium, and the cheapest way of getting dollars would be for John Bull to turn his pounds into gold, which the Bank of England would have to supply, send the gold to America and there have it turned into dollars,

which would be supplied by the United States Federal Reserve banks, and have the dollars paid to Cousin Jonathan.

This example shows the practical working of the gold standard. By means of it, all the countries that use it (which means all the leading financial countries of the world), and all those that use arrangements which hitch their moneys on to it (which means all the countries, except China, that count for much in international commerce), provide their citizens, in exchange for their own local legal tender, with some means of paying debts abroad, either gold or foreign money that can be turned into gold; and in all these countries also the chief bank or banks will take gold that is brought in and give, in exchange for it, the local legal tender of the country.

And so a stock of gold, or of foreign currency that can be turned into gold, is a necessary part of the equipment of a central bank, so that it may always be ready to fulfil its duty of turning its notes into gold when gold is wanted, as in the example given above, for shipment to another country. This 'convertibility of the bank note' is regarded as the corner-stone of a country's financial stability. If it is lost, the door is open to currency depreciation and all the evils which follow from it when it is carried to excess.

On the stock of gold in the central bank, or central banks, the country's supply of money is

built up. Against it the central banks issue notes which are legal tender money, and have to be taken in payment by any creditor for any sum. The extent to which they can issue notes in relation to their stock of gold is regulated by law. The central banks can also provide money (1) by lending, usually to the other banks – the 'commercial' banks which deal with the general public – sums which the commercial banks do not withdraw in notes but leave at the central bank as reserves to be drawn on if wanted; and (2) by buying bills of exchange and other securities. The extent to which central banks can thus create deposits for the commercial banks and other customers, if they have any, is also usually regulated by law in relation to the amount of gold that the central banks hold. In the United States, for example, 'each reserve bank must have a gold reserve of 40 per cent. against Federal Reserve notes and 35 per cent. gold or lawful money against deposits,' as we are told by Dr. Burgess in his lively and lucid book on the *Reserve Banks and the Money Market*.[1] In England, the Bank of England can only issue notes against gold, apart from £260,000,000 worth of notes – its 'fiduciary' issue – backed by securities; but there is no legal limit on the extent to which it can create deposits, by making advances, discounting bills or buying securities.

On this supply of credit, in the form of notes or

[1] Harper & Brothers.

deposits at the central bank, the commercial banks build up the credit that they supply to the community, by lending to their customers and by buying securities and bills of exchange. By these loans and investments they create the deposits on which you and I and all their other customers draw the cheques, in which by far the greater part of the commercial and financial transactions of to-day are settled and quitted, at least in America and Great Britain. (For a description of the process by which the banks, by lending and investing, create deposits for the public, I must refer you again to *The Meaning of Money*.)

Thus we see that, on the basis of their gold stock, the central banks produce notes and credit which form the reserves of the commercial banks, and the commercial banks, on the basis of these reserves, produce credit for the public, which the public uses by drawing cheques against it which are cancelled out against one another in the bankers' clearing-house. The notes and the deposits, and the token coins of silver or base metal, are the money of the community, now that gold is rarely seen. In some countries, notably in the United States, the amount of deposits that the commercial banks are allowed to hold is regulated by law in relation to their reserves. In England the proportion of cash to deposits is left to the discretion of the banks.

So now we begin to see the importance to the

whole community of the extent of the central bank's holding of gold. An export of gold, unless the central bank expands its advances or investments, will mean that the notes or credit issued by the central bank will be reduced; and this will mean that the cash reserves of the commercial banks will also be diminished, and they may be obliged, or think themselves obliged, to reduce advances to their customers or dispose of securities so as to bring their deposits down to the proportion required by law or sanctioned by custom.

To protect themselves, and the community that they serve, against a continuance of gold exports that would involve these dangers, central banks do what everybody does who is asked for more of an article than he wants to part with, namely, put up the price of it. They raise the price of credit by putting up their official rate of discount, and so make money dearer.

By so doing they affect both the commercial and financial activities of the country in such a way as to check the outward flow of gold. Because money is dearer, merchants and others who have stocks of goods that they are carrying on borrowed money will be impelled to sell them, and there will be a weakness in commodity prices which will make the country a good place to buy in and a bad place to sell in; and so imports of goods will tend to be checked and exports to be stimulated, and this will mean that the stream of foreign payments will be

turned, and, as we saw in the example of John Bull and Cousin Jonathan on p. 152, it is the pressure of demand for foreign money in order to pay foreign debts that sometimes makes it cheaper to send out gold than to buy foreign money in the exchange market. Also, because money is dearer, those who are carrying stocks and shares in the stock markets on borrowed money will at the same time be impelled to sell them, as our speculating friends know to their cost; and so securities with an international market will be cheaper to buy in the centre where money is dearer, and this will help to turn the stream of payments inwards; and, finally, in the money market, rates allowed on deposits and discount rates on bills of exchange will be higher, and so the stock of floating money that goes from centre to centre, looking for fat rates, will come along like the flock of seabirds when something juicy goes overboard, and the outward flow of gold will in due course be stayed.

This system carries with it the immense benefit to the trading community of keeping fluctuations in rates of exchange within narrow limits, so that those who sell goods in foreign countries can count on turning the money, in which they are paid, into their own local money, at a minimum price on which they can count with fair confidence. And when it is worked reasonably, and on lines that can be looked on as more or less regular, it secures its benefits without inflicting sudden and unnecessary

shocks on the commercial and financial army and the speculating camp-followers.

In pre-War days gold used to go to Egypt and to America from London in the autumn, to pay for and finance the cotton and wheat crops, almost as regularly as the swallows flew south; and it used to come back in the spring (except what was buried by hoarders in Egypt or went on to India to be buried there) to provide the interest payments that America then used to owe to Europe. Cheap money in the early part of the year and dear money in the autumn were almost looked on as part of the scheme of the universe. And though the working of the gold standard was never quite automatic, and the Bank of England's Court of Directors exercised a wide discretion touching movements in Bank rate, the regular ebb and flow of the monetary tide could not only be anticipated and allowed for by speculators, but could be used by them as a source of profit – selling securities in May and buying them back in November was a system that in most years paid the professional operator who could watch the signs of the monetary sky; though, on occasion, some unforeseen incident would upset his calculations with untoward results.

This more or less regularly working system was smashed by war, like a glasshouse that is shattered into fragments by a shell. And now, although all the chief civilized countries of the world have painfully worked their way back to the gold standard,

after most uncomfortable experiences with unregulated paper, it has not yet been possible to restore the gold standard to its old regularity and smooth working, still less to improve it, with the better and more scientific control that is clearly possible. It has struggled on to its feet but is not steady on them; and its staggers make stock market movements more than ever baffling, and mistakes about their course more than ever costly to those who commit them.

For smooth and comfortable working, the gold standard requires that the central banks of those countries which possess stocks of gold far above their legal needs, should keep their official rates comparatively low; so that they may be cheap centres to borrow in, and so that countries which are losing gold may be able, by means of the measures described above, to turn the tide of international payments and get gold from the place where it is abundant. If the central banks of the countries with big gold stocks quote a low official rate there will be a tendency for prices of commodities and securities to rise in their markets, they will be good places to sell in, and their poorer neighbours, who need, or think they need, a larger gold stock, will be able, by sending them goods and securities, and raising loans in their receptive market, to turn the golden tide in their own direction. As we have already seen, the Bank of England, in the years from 1894 to 1896, when its

gold stock was swollen by the early output of the reefs of the Rand, kept a discount rate of 2 per cent.

But since the War this policy, so essential to the regular running of the monetary machine, has been conspicuous by its absence in the country which is now most powerful in the world of finance.

In America the banking authorities found themselves confronted by a veritable *embarras de richesses*. Dr. Burgess tells us that 'Federal Reserve credit policy has encountered perhaps its most perplexing problem since the War in the huge import movement of gold which has increased the monetary gold stock of the United States from $2,700,000,000 in June 1920 to $4,600,000,000 in March 1927.'[1] The banking authorities were a new body created under the Federal Reserve Act, which became law in the early days of the War, and they had to work for a public which was, beyond all other publics, prone to speculative optimism, often followed in old days by exaggerated depression, and was not accustomed to the regulation of its monetary affairs by a central body. Moreover, the new Act had, by lowering drastically the proportion of reserves to liabilities imposed by law upon the commercial banks, made possible a huge expansion in the credit that the commercial banks provide for their customers. It was evidently a position that needed careful handling, and may well have induced extreme caution in the minds of an inexperienced

[1] *The Reserve Banks and the Money Market*, p. 240.

body, working a new machine in conditions to which there was no parallel.

At the same time the financial strength of the United States was so overwhelming, that their banking authorities had nothing to fear externally. They held all the world in fee, on debts contracted during and after the War. Their trade balance, helped by a fiscal policy which puts a stiff bar in the way of all goods that they do not produce themselves, is normally 'favourable' – that is, they export a greater value than they import; and their foreign expenditure consists of the sums spent by American tourists on travel and hotel bills, or sent, by way of charity, to poor relations in other countries, or lent to industry and public authorities abroad. They only had to reduce foreign travel, charity, and investment, and the flow of international payment would have turned in their favour.

In this position of strength, one might have expected the American monetary authorities to have quoted official rates which would have made New York, Chicago, and the other Federal Reserve centres the cheapest markets for credit and capital in the world, and allowed gold to go abroad freely, until the gold reserves of the Federal Reserve banks began to approach somewhere near the legal limit, with, of course, any margin that banking prudence might require; keeping, in the meantime, a watchful eye on the prices of commodities, so that any tendency to inflation in them, inflicting hard-

ship on the general body of consumers, might be promptly checked if it appeared.

Of such inflation there has been no sign in recent years, but as every one knows there has been an immense rise in stock exchange prices for common stocks, and in the amount of credit used in carrying an open account in Wall Street of unparalleled dimensions; and the Federal Reserve authorities have thought it necessary to try to check this use of credit, by raising Reserve bank rates, by appeals and warnings, and by influencing the 'member banks' – the commercial banks which bank with them and borrow from them – against furnishing credit of this kind.

This policy has been extensively and bitterly criticized in America. That the credit used in Wall Street was not starving industry seems to be clear from the fact that American industry has been for several years busily engaged in beating its own records; and that the endeavour to check Wall Street's activities by dear money failed, was shown by the ever-growing total of brokers' loans, and the frequent recording (up to September 1929) of a 'new high' by favourite securities; and by the fact that the October reaction followed a spell of comparatively low rates for money.

What strikes the outside world as anomalous is, that in the latter half of 1928, though the Federal Reserve system had a proportion of gold to notes and deposits that was nearly twice as large as was

required by law, New York was a dearer centre to borrow in than London (whence London indulged in rather too hasty self-congratulation about having got back its position of the chief monetary centre), and that gold began to move to America, where its arrival only encouraged the speculators and so produced just the effect that the banking authorities did not want; and that in the spring of 1929 their efforts to make credit dear in Wall Street screwed the call-money rate there up to such a height, that all the impoverished outside world was sending money to the richest nation on the earth, to finance the speculation that its banking authorities were trying to stop; and so credit and capital were made scarce and dear in places where they were badly wanted, for industry struggling towards recovery.

Such were the effects of the monetary policy of the United States Federal Reserve Board, which, as we have seen, had special difficulties of its own to meet, and may have been justified in thinking that what happened to the rest of the world did not concern it, so much as taking thought for the needs of those who live under its monetary sway.

In these circumstances, it was obviously the policy of the central banks of Europe, which could not possibly hope to compete with America in a scramble for money, to co-operate among themselves in the economical use of gold, and to let gold go to America until the Federal Reserve Board tired of pulling in metal that it did not want, and

that speculators whom it was trying to discomfit, wanted and welcomed as a 'bull point'; and, in the meantime, to cause as little monetary disturbance as possible on this side of the world. Instead of which they started a gold scramble on their own account.

Of all countries it might have been expected that Germany, being a chronic borrower and having heavy foreign engagements to meet on Reparations account, would have been most anxious for a smooth and easy money market in the lending centres. And yet a drain of gold to Germany was an unexpected strain on the Bank of England in the autumn of 1928, and has continued intermittently since then, with the result that from 1st February to 29th August 1929 England exported nearly £16,500,000 in gold to Germany, while £18,000,000 went to France, and £8,000,000 to the United States.[1] That Germany should borrow to replace her working capital, dissipated during her period of currency depreciation, is most reasonable: but that she should keep her central bank rate screwed up to a point at which it sucks in gold and so checks her ability to borrow and upsets the world's capital market, looks like very clumsy mishandling of a difficult position.

And what of France, famed for tact and *finesse* and delicacy and grace, in thought and speech and action and *cuisine*? The skill and confidence with

[1] *Times*, September 18, 1929.

which she stabilized her franc without any assistance from outside was a financial masterpiece, but in her handling of the gold standard she has been as heavy-handed as her Teutonic neighbours, and with much less excuse. In the spring of 1927 she suddenly startled the world by taking big shiploads of gold from New York and London, because, so it was blandly explained, she did not want the recovery of the franc to go too fast and far; and so she wanted money to be dear abroad, so that expatriated French funds, which had gone overseas during the 'flight from the franc,' might prolong their change of air. This year, as we have seen, she has been a voracious importer, and at the end of July 1929 more than £8,000,000 was taken from the Bank of England in one week, nearly all of which was shipped to Paris.

Two facts made this movement look especially unnecessary and strange. One was the already immense strength of the Bank of France, which had at that time nearly twice as large a gold stock as the Bank of England's (it is more than twice as large now[1]), and also had over £200,000,000 worth of sight deposits and bills held abroad, which put it in a masterly position to control movements in exchange. The other was the low discount rate – 3½ per cent. – quoted by the Bank of France. The Bank of England's was then 5½ per cent., so

[1] On September 25, 1929 the Bank of England had £133,213,000 in gold; the Bank of France (on September 27) over £317,000,000 in gold and £209,000,000 in sight deposits and bills abroad.

that according to all the rules of the game, as it was played when it had any rules, funds ought to have been moving from Paris to London, to batten on the higher rates there current. But the low French Bank rate was largely an empty symbol, signifying nothing. *The Times*, in its City article of 20th September 1929, explained that although France had a Bank rate of $3\frac{1}{2}$ per cent., she had an official advance rate of $5\frac{1}{2}$ per cent., 'and her industrialists and traders find that bank loans cost them 1 to $1\frac{1}{2}$ per cent. above this figure – namely, $6\frac{1}{2}$ to 7 per cent.' In England, the general charge for bank advances, with a Bank rate of $5\frac{1}{2}$ per cent., was $6\frac{1}{2}$ per cent., so that, with a Bank rate lower by 2 per cent., French industry had to pay more than British for accommodation, which looks like a rudimentary condition of monetary organization. Since money was wanted in France, and the French banks did not think fit to discount bills at the Bank of France at its official rate (being, presumably, discouraged from doing so), they found it simplest to finance themselves by taking part of their balances in London home, in the form of gold.

Which, of course, they had a perfect right to do, and London, which boasts of its free gold market, has no right to squeal when its customers make use of it. All that I am concerned to show is that the working of the gold standard has lately been a silly farce – all the sillier for being so serious. When a

country whose central bank has an enormous gold stock and a low Bank rate finds it necessary to bring home funds in gold from a place where Bank rate is 2 per cent. higher; when another country, eager and industrious and much in need of foreign funds, takes gold away from a lending centre and dries up its lending power; and when another country, the richest and most prosperous of all, adds gold to an already bloated heap and thereby stimulates the speculation that it is trying to check – when such *jeux d'esprit* as these are in the programme, speculators take their lives in their hands when they venture into markets always highly sensitive to monetary shocks.

And while these strange things have been happening, learned economists have been telling the world that there is not going to be enough gold to go round, unless the central banks are very careful to co-operate in its economy, and a committee at Geneva has been discussing measures for the promotion of this necessary co-operation; and the experts at Paris, who were asked to settle the question of Germany's capacity to pay, found it easier to begin by recommending the establishment of a Bank for International Settlements, saying that 'it is to be hoped that it will become an increasingly close and valuable link in the co-operation of central banking institutions generally – a co-operation essential to the continuing stability of the world's credit structure.'

With these last words we shall all agree. But whether the new bank will assist in co-operation or intensify gold-grabbing, remains to be seen. For, according to its proposed constitution, the governors (or their nominees) of the central banks of the seven chief nations that were engaged in the War are to sit on its Board and direct its operations – a 'thing the imagination boggles at,' in the light of the recent performances of some of them.

An incidental fact that makes the farce all the more ridiculous is, that while Europe is terribly afraid of America's financial domination, her central banks, by thus making gold scarce and dear, are working to tighten America's hold on Europe. For Europe owes America vast sums payable in gold, and as gold is made scarce and dear by the action of the European banks, and its value in commodities rises, those debts will be more burdensome to Europe and more profitable to America.

For this state of things there are two consolations. One is the stout imperturbable calmness with which the Bank of England has met it, only raising its rate under the stress of exorbitant demands for gold, and showing other centres that it is a banker's business to use reserves and not sit on them. The other is the fact that special circumstances have accounted, to some extent, for the strange vagaries of these troublous years and that they are not likely to continue.

Germany, with the Reparations question brought up for resettlement – quite unnecessarily and prematurely, as many people think – had causes of anxiety which may have accounted for her strange operations in the bullion market; these anxieties have vanished, we may hope, now that the Hague conference has endorsed the arrangements made by the experts at Paris.

France, we are told, has been consolidating her position as a great financial centre, and with that object has been stacking up gold in the vaults of the Bank of France. That Paris should be again, as she was before the War, a rich fountain of capital for borrowing countries, is an ambition which is fully justified by the wealth and thrift of the French people, and all the world will be glad to see it gratified. But it must, surely, soon dawn on that logical faculty of which our French friends are so justly proud, that a great financial centre is one that does not hoard metal, but lends freely; and that making gold scarce for the benefit of the American creditor is a queer way of starting those United States of Europe, one of the objects of whose establishment is supposed to be the erection of a united European front against the domination of the Western money power.

CHAPTER XI

SPECULATION, SOUND AND UNSOUND

Sound Speculation a Duty – To those who can Afford It – Encouragement of New Enterprise – Bad Company Promotion – Appeals to the 'Authorities' – The *Economist's* Inquest on 1928 Promotions – Wanted, Better Promotions – And a Better Educated Public – The Small Gambler – Helpless in Competition with the Insider – Mr. Moseley's Advice to Speculators – Even in America the Weak Lose to the Strong – Otherwise, How Much Harm does Speculation Do? – America's Combination of Speculation, Prosperity, and Industrial Activity.

At the beginning of this book I mentioned, among the things that it was going to try to show, the contention that speculation, in the sense of gambling for the rise in stocks and shares, is so risky that it is not worth while for ordinary folk, because the odds are always against the outsider and in favour of those who are on the spot to skim the cream off markets.

In another sense speculation may clearly be not only harmless, but a duty which those who can afford it (for it is always risky) ought by no means to neglect. Mr. Hoover has recently declared that 'without adventure there is no progress,' and it is evident that if nobody ever took a risk, there could be no invention or experiment or enterprise.

Inventors and experimenters risk their work and their time and occasionally their lives; and also their money if they have got any. But as they generally have not nearly as much as they want, to carry out their experiments, they have to be financed by those who have money but have not the gifts necessary to invention. So that all those who have more than enough money to keep themselves and their dependents in comfort, and to guard them against the risk of being a burden on the community, are bound, in the interests of progress, to put some of their surplus at the disposal of invention, by making investments which are frankly speculative, in untried enterprises that are not yet proved as 'commercial propositions.'

Unfortunately, the methods by which enterprises of this sort are at present introduced to the public are often far from satisfactory; and also, when such enterprises are brought out, especially at a time when the public is in a speculative mood, they often attract subscriptions from people who have no right to go into them, because they have not the surplus that enables them to face, with equanimity, any losses that may ensue. And then, if loss comes, instead of blaming their own imprudence they jump hastily to the conclusion, like King David, that all men are liars, and go on to the equally incorrect conviction that all investments are a fraud, and that the best thing to do with money is to spend it on 'having a good time.'

As usual, when there has been a crop of occurrences of this kind, suggestions have lately been rife, to the effect that the business of company promoting should be put under stricter supervision. This view was expressed, though with due caution, by Mr. Paul Lindenberg at the meeting on 17th September of the Industrial Finance and Investment Corporation, which, as he was able to tell the shareholders, had, during the year under review, been interested in several issues that had been quite successful and had proved, like those of preceding years brought out under the same auspices, 'sound and reliable undertakings.' Mr. Lindenberg, having reviewed the result of an 'inquest' that the *Economist* had published (as to which more anon) of the results of companies brought out in 1928, went on to say: –

> 'Although I should be sorry to see anything done which might have the effect of checking new enterprise, at the same time I think it would be advisable for our authorities seriously to consider means for preventing the waste of capital which the public suffers through ignorance and lack of suitable advice. Companies issuing capital under the auspices of responsible issuing houses have their undertakings subjected to the very strictest investigation, and therefore the public can employ its money in such concerns with full confidence.'

This danger, indicated by Mr. Lindenberg, of

checking enterprise, is very real. If the 'authorities' mean the Government, and if the law is to be made so strict that company promotion is bound hand and foot in legal shackles, check on enterprise is almost certain to happen. If, as many people urge, the Stock Exchange Committee were to insist on much fuller information about the prospects of companies before they give permission for their shares to be dealt in, two obvious objections arise. The first is that the Stock Exchange Committee would be expected to pass judgment on technical and scientific matters which is beyond its province; and the second is that it would be asked, in effect, to guarantee the success of any company whose shares it passed for a quotation. For though there would be no such guarantee in fact, the public would be very certain to assume, if this stricter investigation were made by the committee, that any company which passed it was 'A1, copper bottom.'

What is wanted is that the machinery of company promotion should be managed by better hands. Hitherto, the great London issuing houses have confined their attention chiefly to Government and municipal loans, and in the old days when America still needed outside capital, to American Railroad bond issues. Small companies, involving speculative risk, were not, from their point of view, worth while. And so the issue of the small companies in which the small public might be expected to take an interest got into hands that were not

always of the cleanest, and the companies were too often brought out with nothing but possibilities behind them, at much too early a stage of the enterprise's development, and capitalized in such a way that the public which found the money did not get a chance of a fair run for it.

At the same time there is no need to paint the picture with nothing in it but darkness and shadows. Even when we contemplate the disastrous failure of the 1928 vintage, we may remember that a certain number of bottles from it, when they have been laid down for a few years, may have a grateful smack on the investor's palate. At present it makes a very sorry show, as analysed in the article in the *Economist* of 17th August 1929, already mentioned. The writer had set himself the task of estimating the toll taken by the speculative public issues made in the industrial share boom of 1928. Under the term 'speculative' he included the shares of every company formed to start a new business or to develop a new patent. 'Strictly speaking,' he writes, 'any company formed to take over and enlarge an existing business should be regarded as a speculation – how many attempts have failed to turn a successful private business into a large public company! – but for the purposes of our present review we have excluded every concern with a respectable past history. In other words, we have given the promoter the benefit of the doubt, whenever possible.'

But is this last observation correct? Surely an investigation which directly excludes all the companies that had the best chance – those, to wit, which had a respectable past history – is hardly giving the promotor the benefit of the doubt, but showing the results only of those of his efforts which were most likely to be disastrous. It is like only backing horses whose past form is most unpromising, and then being surprised to find most of them in the 'also ran' class. If all the companies issued during the period had been taken, instead of the selection being confined to those that had the worst chance, the result of the analysis would have been different. Even after making this allowance, however, the result is sufficiently disastrous. The *Economist* continues: –

> 'We estimate that the new companies of 1928 falling within our definition of "speculative" concerns numbered 128, of which six belonged to the safety glass manufacturing industry, nine to cinematograph film production, ten to the artificial silk trade, nineteen to the exploitation of patents such as automatic machines, photographic films, etc., and fifty-three to miscellaneous speculative trades, including a few mining gambles. Let us see how the public has fared as a result of these speculative issues.'

Then follows a detailed table, after which: –

> 'It will be seen that the present market valuation of all the shares issued to the public by these

128 companies is £17,400,000, as against a par value of over £30,000,000. If the original subscribers bought their shares at par, and have since retained them, they have lost 42·3 per cent. of their money, while those who purchased 'at the top' have suffered a capital loss, on the average, of 54·86 per cent.'

It is a dreadful result. But, apart from the fact that the examination was confined to such concerns as lacked a 'respectable past history,' we have to remember, when deploring it, that the period in which these losses were made by subscribers to, and purchasers of, new issues was one in which the prices of old-established securities were also going to pieces. This was partly owing to the Bank rate nuisance, and the vagaries indulged in by the central banks abroad, as described in the last chapter, and partly owing to special causes affecting certain industries.

As evidence of the sickness that was eating away prices in nearly all markets at this time, we need only look at the Monthly Securities Index of the *Investors' Chronicle*, as shown in its issue of 3rd August 1929. 'The index figure,' it tells us, 'for all securities is now lower than for any month since September 1926. The figure for all business securities is now lower than for any previous month since June 1927. The gilt-edged figure is lower than it has been at any previous period since the basis of our index was taken as 100 at the end of

1923.' And when we look into the details of the *Investors' Chronicle's* very interesting table and see that between May 1928 and July 1929 there had been a fall of 46·9 per cent. in silk shares (chiefly, no doubt, caused by the catastrophic fall in British Celanese), and of 10·8 per cent. in the average of all the securities that it includes, it is evident that the 1928 promoter is not the only villain in the piece, that some of the weak birds bred by the bad finance of former years were coming home to roost, and that the distinguished gentlemen who were playing strange tricks with the gold standard had also been helping to upset the apple-cart. (If these metaphors are mixed, so were the causes of the upset.) But when all this has been said, and even if, as we may fairly hope, the general consumer, who is the person who matters most, may get something out of it in the shape of cheaper safety glass, art-silk, gramophones, photographs, and other necessaries and comforts and nuisances, the losses caused to those who speculated and invested in that 1928 boom must be a nightmare to all who were even remotely connected with it. It is easy to say that it was the public's own fault. It has been told over and over and over again that any new venture is necessarily speculative, and that those who speculate with money that they cannot afford to lose are born to trouble as the sparks fly upward. But events of this kind bring our whole financial machinery into disrepute, and the City cannot afford, in these critical

days, to leave anything undone by which the machinery of company promotion can be improved, so that the public may be protected against its incurable and very natural craving for getting rich quick, without unpleasant exertion, and its habit of trying to do so by methods that leave it poorer.

There are two ends at which the problem can be approached. One is the development of companies such as the Industrial Finance and Investment Corporation, which has Lord Melchett and others prominent in industry and finance on its Board, and has set a high standard in the matter of the enterprises that it has put before the public. If there were more companies of high standing, prepared to examine inventions and enterprises, nurse them if promising until they are sufficiently proved for public issue, and see that they are capitalized in such a way that those who find the money will be reasonably rewarded if success is achieved, then we should hear less of that long-standing reproach against the City, that it leaves the field of company promotion open to the growth of weeds, because those who can farm it in the right way will not trouble to do so.

At the other end is the education of the public, which proceeds to little purpose because investment responsibilities continually come into hands that are new to them, but *e pur si muove*, – it does move. Bitter lessons have been learnt in these last two years, and at least it can be said that the recent

remarkable growth of the Investment Trust company idea shows that a large number of investors are beginning to find shelter in this haven, the smooth waters of which will be described in my next chapter.

But even if company promotion were reformed out of all recognition, and if all speculative investors could be persuaded to forswear sack and live cleanly in the serener atmosphere of Trust company stocks, there would still be the speculator pure and simple, who buys a few shares, often with borrowed money or on margin with a touting firm, who does not waste his or her time in trying to find anything out about the shares, but takes tips from friends or from newspapers, or from conversations overheard in a bus, and relieves an otherwise dull existence by trying to make a little odd money out of the City.

When markets are rising, folk like this live on one another, except in so far as those who do their business live on all of them. Every time that a favourite share rises, all those who have backed it tell their friends about their winnings, and so a fresh batch of buyers is hatched, and, as they say in the City, 'when once the public is really on the feed, there is no top to anything.' And when the bottom falls out of the price, as it may do for some reason wholly unconnected with the fortunes of the company, it is the small, weak speculator, who can find no more margin, who is left wailing, while the 'strong hands,' with plenty of credit behind them,

can hunt leisurely for bargains, cheapened for them by the impecuniosity of those whom the City calls the 'mugs.'

And whenever these things happen, those who are in the centre and on the spot and 'in the know' (though this last position is sometimes extremely dangerous and expensive) always have an advantage over the outside public, however carefully the latter may study the prices in the evening papers; because to be able to close a commitment at once, before the bloom is off the cheek of a market, will often make all the difference between profit and loss, and is certain to make a big difference to the extent of the loss, if it has to be faced. Time and quickness are an element in success in speculation, and plenty of money, or credit, is another; and in both these the outside public is hopelessly behind the professional operator, steeped in the atmosphere of markets and sniffing the changes in their sentiment through a specially developed mental nose, and with a knowledge of credit facilities sharpened by many a breathless turn round a difficult corner.

But lest these warnings be disregarded as mere assertions by a quill-driving theorist, let me quote some of the doctrine of Mr. Sydney A. Moseley, who has written a book called *Money-making in Stocks and Shares*,[1] based on very practical and varied experience in the art of so doing. So highly is his practical judgment respected, that he acted

[1] Published by Sir Isaac Pitman & Sons.

for a time as 'intelligence officer' to a firm of London brokers and during this period had lists of securities sent to him for overhaul by many big business men. He had spent 'many years and much money in trying to bring off a *coup*,' had lost his first fortune, vowed never to touch another stock or share unless it had the hall-mark of British Government security, and then, by 'persevering to the end, and with the vital piece of luck,' got it all back and a good deal more.

Here is one who speaks with authority and not as the scribes, though Mr. Moseley is, in fact, a versatile author among other things, and the first impression that one gets from his most interesting book is that successful speculation is a wholetime job, not to be interrupted by such prosaic pursuits as trying to earn one's living by less romantic methods. He tells us how day after day he found himself willy-nilly directing his footsteps to Throgmorton Street instead of Fleet Street, and how morning after morning he stood about the precincts of the House (which means the Stock Exchange), 'mixing with the most varied types of stockbrokers and jobbers, chaffing, ragging, doing a not inconsiderable amount of business, snatching profits, cutting losses.' Also he had access to the society of the Great Ones of the Earth, though this privilege was sometimes expensive. He relates how when he was in Paris he spent an evening with the First Secretary to a foreign Embassy, the name of

which he tactfully suppresses. In the course of the evening the Ambassador joined the party. A chance remark made by the Secretary led to Mr. Moseley's asking whether a certain deal was likely to go through, and the 'beaming Ambassador' replied that, though one never knows in the world of finance, he would not do any harm if he bought the shares. In the end the evening's entertainment cost him 'a few hundred pounds,' though at the time when he gave it the Ambassador's tip had been perfectly correct. An eleventh hour hitch, which nobody could have foreseen, had upset the programme, and it was said that 'some very big knowing men within the circle of the Embassy had also lost money.'

With such and much other experience behind him, Mr. Moseley advises anyone who is a speculator to begin by asking himself, 'How much am I prepared to lose?' and tells us that 'it certainly becomes a dangerous thing when people speculate with money that they do not possess. That way lies ruin. I refer, of course, to the margin system. . . . By merely paying 5 to 20 per cent. of the total value of the stock purchased by people who have no right to speculate, men and women who are totally uninformed on the subject purchase securities which give them little or no chance of profit. That is an evil of our present-day system that ought to be checked. For it hits the very people who can least afford to lose their money. . . . Avoid

margins therefore as you would the plague. Throw into the waste-paper basket any offers of 'fortunes' which are yours if you are willing to pay a percentage of the total cost of certain securities.'

Even in America, where the almost unbroken rise in prices of common shares during eight years gave the outside public an unusual chance of making money out of markets, the occasional relapses that marked the triumphant course of the boom hit the small man and helped the big one. When in March 1929 the rate for call-money in Wall Street touched 20 per cent., and again in August of the same year, when the sudden raising of the New York Federal Reserve Bank's rate to 6 per cent. shook the stock markets of both hemispheres, it was the small, weak punters who had to rush to cover and suffered losses of many millions of dollars, which were turned very quickly into profits for the strong holders, who came to the rescue of the market, steadied it, and started it once more on its upward course.

But apart from this tendency – which may almost be called a certainty – of stock market speculation to hit those hardest who can least afford to bear its blows, and apart also from its moral effects, which are, fortunately, outside our present purpose, one may beg leave to doubt whether it is as harmful as is often assumed. We have seen it at work in America during eight years in which the general prosperity of the country has been the envy of the rest of the world.

'Since August 1921,' says Professor Irving Fisher in an article in the *North American Review* for July 1929, 'the Standard Statistics index of common stocks listed on the New York Stock Exchange has risen 260 per cent. Never before has there been so long and rapid a rise in stock prices. Never, either, has there been so rapid a development in national resources, in improved technology.'

We on this side have been staggered by the enormous volume of the 'brokers' loans,' but in looking at such figures we have to bring them into relation with the immense totals that statisticians put against American wealth and production. Even when we compare them with the value of securities quoted in New York, they begin to look much less alarming. Mr. Simmons, President of the New York Stock Exchange, shows on p. 187 of his book, *Modern Capitalism*, that on 1st January 1927 stock market loans amounted to only 4·35 per cent. of the total value of the listed securities. Since then they have more than doubled in amount, and the ratio to market value for July 1929 is stated at 8·87 per cent. by a Survey of Current Business Conditions published by the United States Department of Commerce. In March 1929 it was 9·75 per cent. Even this is not too staggering a figure, especially when we remember that, as Mr. Simmons points out, these loans finance the distribution of many issues not listed on the New York Stock Exchange.

That the diversion of this mass of credit to stock

market purposes dried up the supply available for industry was strenuously denied by expert American observers. On the contrary, the huge market for common shares, widened by these credit facilities and by the modern doctrine which preaches that they are the safest for investors, and by the speculative promises and performances that have made them a happy hunting-ground for speculators, enabled companies not only to finance all their current requirements by issues of common shares, but also to pay off loans from banks and redeem outstanding bonds. So common has this practice been that Professor Edie of Chicago University calls attention to it as giving a false appearance to the reports of company profits. 'A corporation,' he says, 'which has, by issue of common stock, raised funds wherewith to pay off its loan at the bank and to retire its bonds outstanding will henceforth carry no bond interest expense account. Hence the accountant will make no deduction from gross earnings for this form of expense. Nevertheless, in the future, the corporation will pay dividends upon the newly issued common stock. Such dividends will be a part of net income, not an expense deducted before net income is arrived at. But the new dividends are merely the equivalent of what formerly was paid out in interest. Under the new set-up net income will appear to have increased, but the increase will not be real. . . . In reading corporation reports,

careful attention should be given to this shift in methods of raising capital.' [1]

Another American authority tells us that the increasing appetite of the investor for stock bonuses has enabled many companies of large earning power to forgo the payment of cash dividends in part or entirely, with the result that most or all of the net earnings remain in the companies' possession. 'Thus the holder of common stocks and the stock market can be said to be performing a part of the duties which were formerly the province of the banks. And the new stockholder, who feels the need of some help to carry his investment, is now in turn seeking this aid from the banks in the form of a broker's loan. In some instances the corporation itself is lending the funds, which are used through the medium of the bank.' [2]

It thus appears that so far from industry being hampered by any scarcity of credit due to stock market activity, industry has been lending to its shareholders money to carry new stocks issued to them, having saved this money by forgoing cash dividends – so that the shareholders are, in effect, borrowing their own money. To old-fashioned observers on this side this looks like queer topsy-turvy sort of finance, but the stockholders evidently like it; and for a long time made fine profits, in the aggregate, out of borrowing money, which they had

[1] *Capital, the Money Market, and Gold*, p. 10.

[2] From a circular on 'The Outlook for 1929' issued by Messrs. Schröder of New York.

failed to receive by the absence of cash dividends, in order to pay for their stock bonuses.

And in the meantime there was no evidence that speculative activity had diverted energy from industrial expansion and progress. No one can accuse the American people, as a whole, of neglecting its job in order to watch the ticker. Opportunely, as I end this chapter, there arrives one of those monthly communications from the Commercial Attaché to the American Embassy which tell one, on the authority of the United States Department of Commerce, how our kinsmen across the sea have been faring on the material side of life during August 1929; and as usual the tale is a pæan of almost unbroken triumph – production in the iron and steel, automotive, building, rubber, and minor industries high, making new records in some cases; sales maintaining an 'excellent level'; car loadings well above those of the last three years; commercial failures below those of 1928, both in number and liabilities; the stock market showing a 'remarkable advance to a high record for all time,' with sales in August more than two million shares ahead of the July total; in spite of a rise in the New York Federal Reserve Bank's official rate on 9th August, loans secured by stocks and bonds rising to $6,217,000,000 on 28th August, a new record, and nearly two billion dollars above that of a year ago; imports and exports in July the highest for that month since 1920.

The only shadows in this glowing picture are the dullness of the textile industry, with serious strikes in the South, the downward trend of the bond market, with its average price the lowest since 1925, and a 'disturbing' credit situation. Since, however, the ratio of total reserves to deposits and Federal Reserve note liabilities increased during the month from 74·4 to 75·4, and since, as was shown on p. 154, the law requires only 40 per cent. for notes and 35 per cent. for deposits, the figure of 75·4 shows an enormous margin of strength. If this is a disturbing credit situation, some countries on this side would be glad to suffer a little disturbance.

In the midst of this staggering aggregate prosperity there is, of course, room for plenty of hardship, and a letter printed in *The Times* of 21st September 1929 from Professor Eastman, of Chicago Theological Seminary, gives a timely warning against the English belief, as he finds it rife, that poverty and struggle have become strangers to the United States. 'On the contrary,' he says, 'we have more than enough of both,' and he tells us of 'starvation wages in the non-union mills of the South,' that tell a story 'almost as harrowing as that of the Welsh miners'; more than 3,000,000 men out of work last winter; 640,000 farmers leaving their unprofitable farms in 1927; 3,000,000 leaving them since 1920; and he says that of the 100,000 American tourists who came to

England this summer, probably not one in twenty has a servant in his home, and not one home in five is without mortgage.

It is well that we should thus be reminded that even at the American feast there were skeletons, and that there, as in all other countries, the better distribution of wealth is an even more urgent and much more difficult problem than its production. But our present purpose is to try to trace the effects of speculation on the prosperity of the United States as a whole. And when we look back at the official tale of record-breaking industrial expansion, in spite of speculation on an unparalleled scale, and then remember the effects on the money markets of the world of the American banking authorities' efforts to check the speculation, we in the impoverished Old World may well wonder why our wealthy creditor should have hit us so hard, in order to try to check a movement which seems to have done, at least until the time of its collapse, no material harm to the country as a whole, and which finally boiled over on its own account, as it was bound to do some day. It is not good business for a creditor to hamper his debtors' productive efforts.

CHAPTER XII

A HAVEN FOR INVESTORS

Diversification and Insurance – Through Investment Trust Companies – Of the Right Kind – Which Diversify – And put away all Profits on Turnover – And also Part of Revenue – Their Comparatively Definite Assets – The British Combined Example – The Security of Trust Company Debentures – And Preferences – The Ordinary Stock – Publication of Securities – Limited Trusts – What some Trust Companies have done in Twenty Years.

WHAT have we got in the bag after this long day at the butts? Most of the birds that we have brought down will look rather scraggy when they come to table, for their flesh consists chiefly of difficulties exposed and uncertainties noted. Before we cease firing and go home we must try to lay something on the heather that will provide more satisfying food.

If it be true that Government accounts are incomprehensible to amateurs and a battleground to experts, that company accounts give us interesting but generally incorrect opinions about asset values, are a hazy guide to real earnings and leave out what we most want to know – the quality of the men in charge; that a new theory of investment, telling us to seek safety in common shares requires special knowledge on the part of those who follow

it; and that a certain amount of semi-speculative investment, by which we place part of our funds at the disposal of enterprise, is a duty that all who can afford it ought to perform; if these things are so, what ought a puzzled and bewildered investor to do?

Both Mr. Smith and Mr. Raynes, in their experiments with common shares which were described in Chapters VIII. and IX., laid down distribution of risk as essential, and for obvious reasons. Mr. Smith took examples of investments distributed among ten different stocks. Mr. Raynes distributed £54,000 among the six largest companies of nine different groups. By means of this policy the principle of insurance is applied to investment. Insurance is based on the fact that the risk of fire or death or shipwreck, which is formidable in regard to the case of one building or one person or one ship, is immensely lightened if the risk is spread over a multitude, especially if selection is applied and skilled examination includes only those buildings, lives, and ships which are well found and up to average standard. Insurance works its benefits, for itself and for the assured, because the great majority of buildings never catch fire, most men and women live the normal span, and most ships come safe to port.

Can we apply this principle to investment? Clearly we can, for the great majority of companies and public bodies which issue securities that are

sufficiently well sponsored to be quoted on a stock exchange, return an income to their holders, and anyone who holds a well-selected group of them can more than balance occasional losses on some, by steady or rising incomes from the rest.

And when the small and inexperienced investor replies that this doctrine is of no use to him, because he has not got enough money to spread his risk over a sufficient number of securities, or the necessary skill, time, and knowledge to make the selection, the answer to him is that he can secure both these advantages, and another to be mentioned later, by an investment in the stock or shares of an Investment Trust company. By becoming a shareholder in one of these companies, he is at once part owner of all the securities that have been selected for it by its managers and advisers who specialize on this business, giving all their working lives to it. They also have access to sources of information such as are rarely available to the ordinary investor, and are constantly on the spot, in the very centre of financial movement; and so provide for their shareholders just those qualities, the lack of which was shown in our last chapter, to handicap the amateur who ventures his money in securities.

But it must not be supposed that one is, therefore, justified in blindly buying the stock or shares of any concern which calls itself a Trust company. As nearly always happens in business nomenclature, this word covers companies which do quite different

kinds of work. In America many of the banks are called Trust companies. In England many of the institutions which are called Investment Trusts are finance companies doing development and company-promoting business – very often doing it well and carefully, but necessarily taking risks which are avoided by the pure investment company, which provides a haven for the sort of investor whose interests I am considering. Owing to the great increase in the activities of Trust companies and the important services that they render both to industry and to the shareholding public, it is much to be desired that the different kinds of them should be distinguished by different names.

What I mean by an Investment Trust company is one that gets money from the public by issuing securities to it, and invests this money in a widely diversified selection of all kinds of securities, in different enterprises and different countries, but does not embark in the management or promotion of enterprise or put more than a small part of its funds into any one venture. It is a pure investor, but an investor whose efficiency is immensely increased by the size of the funds that it controls and the other advantages that have already been mentioned.

This is the kernel of the matter, and if I am told that I am a bold man to write about the merits of Trust companies, at a time (September 1929) when the papers are full of the names of companies so-

called that have suffered by the collapse of Hatry finance, my reply is that these companies will not be found to have come within the terms of my description. Also that this fact shows how strong is the case for the restriction of this title to the purely investment type of company.

So essential is diversification and so prone is human nature to forget the need for it and to be tempted to indulge in too much of one security, or of one group of securities, that may happen to look particularly promising, that some definite restriction is advisable, laid down in the articles or rules of the company, by which not more than a certain proportion of the funds may be put into one class of investment.

It is also essential that the divisible income should consist only of the revenue received in dividends and interest from its investments, and that all profits made by the sale of securities should be retained by the company, being either put to reserve, or, as is more usual, used for writing down the book-values of the securities held, and so creating a hidden reserve.

This sound practice is practically universal among the British Investment Trust companies and is encouraged by the income-tax law, which allows them to deduct profits on turnover of securities from taxable income, which clearly could not be done if these profits were treated as divisible income. A full study of British Trust company

methods has been published in a book called *Investment Trust Organization and Management*,[1] by Leland R. Robinson, Ph.D. Dr. Robinson was at one time an American Trade Commissioner in London and studied our Trust companies on the spot; he has since done practical work in assisting the growth of the Investment Trust principle in the United States. On p. 152 of his book he quotes the chairman of the London Prudential Investment Trust as saying, 'Were we to treat as available for the purpose of paying dividends the amount that we have placed to reserve account, we should automatically deprive ourselves of advantages enjoyed by Investment Trust companies in the matter of taxation and would become liable to pay income-tax on that amount.'

Besides this allocation to reserves, whether visible or concealed, of all profits on the sale of securities, it is the practice of the great majority of the well-managed Trust companies to keep back and re-invest every year part of the income received from interest and dividends. An article on Industrial Profits, in the *Economist* of 20th July 1929, gave figures showing that the 127 Trust companies which had published reports in the year ended on 30th June, had kept back an average of 25·6 per cent. of the amount available for ordinary dividend. This is a further advantage that they grant to the investor who puts himself into their

[1] Ronald Press, New York.

hands. They not only earn for him a better income than he could earn for himself, but they keep part of it out of his reach and re-invest it for him, so hitching his wagon to the star of compound interest, harnessing it to work for him and increase his income in future years, with a consequent increase in the capital value of his holding.

It will be remembered that Mr. Smith, as noted on p. 125, found in this fact, of regular allocations to reserves by well-managed companies, the reason why common stocks had come so much better than he expected out of the tests to which he subjected them. Such was its effect that it balanced all the risks of industrial investment and gave common stocks, in the examples that he showed, a uniform advantage over high-grade bonds. Evidently its beneficent effects will be much more regular and trustworthy when it is applied, not by companies which are facing the risks of one industry, but by those which, by being interested in most industries and enterprises in every continent, have increased their stability by diversification carried to the umpteenth degree.

And now that we have gone back to Mr. Smith, let me remind you that he also, after detailing a formidable list of the qualities required by those who follow his doctrine of investment in common stocks, concluded that sound investment management is a task that can be undertaken 'only by an organization in which men of varied experience and

training in the financial field combine, with the single purpose of applying their best combined judgment continuously to the supervision of a single investment fund in which a large number of individual investors may participate.' Which is exactly what the well-managed Trust companies do for their shareholders.

They have this further advantage that most of the doubts and uncertainties which we saw, on pp. 53 *et seq.*, to be attached to some of the most important assets in an industrial or commercial balance-sheet do not bewilder those who look at the balance-sheet of an Investment Trust company. For these doubts were concerned with the values set against such things as land, buildings, plant, machinery, stock-in-trade, debtors, and goodwill, valued by the directors and managers to the best of their ability, and certainly under-valued in the balance-sheets of well-financed companies, but with sums set against them which were of little use as a guide to the earning power of the enterprise or to their probable value if they had to be sold. We found that we only got on to ground that had any pretence to firmness when we came to the cash and investments. Because cash in hand or at bank is a definite certainty and investments in securities quoted on a stock exchange, though they could not necessarily be sold at the price at which they are valued, are much more likely to be somewhere near to being correctly valued, than assets

that are appraised by a process of guesswork however skilful and intelligent.

But the assets of Trust companies consist almost entirely of investments. These investments are not all, necessarily, quoted on a stock exchange, but the great majority of them are, at least of those held by the important companies. It is also true that owing to the practice of writing down the book values of the investments, out of profits realized by sales, book values may have little connexion with market values; also that market values, except those of securities actively dealt in, are sometimes misleading if a large block of stock has to be pressed for sale. But when all these admissions are made, the holding of a mass of investments is a thing that is much easier for a Board to value and for the auditors to check, than a group of assets consisting of bricks and mortar, machinery, materials, half-finished goods, and advances to enterprising but possibly insolvent customers.

This comparative simplicity of a Trust company's balance-sheet and accounts, and the absence from them of most of the illusions which mislead many who study those of other enterprises, will be apparent at once when we study an example, and especially if you will compare it with the industrial accounts examined in Chapters IV. and V. Here is the balance-sheet of the British Combined Investors' Trust, a new company which presented its second report in April 1929. The selection of a new

company had this advantage, that its accounts do not dazzle the beholder with a display of tremendous strength accumulated in several decades, and in times which may prove to have been more favourable to Trust companies than the present and future: –

BALANCE SHEET, MARCH 1, 1929.

Preference stock .	£600,000	Investments (at or under cost) .	£1,659,592
Ordinary stock .	400,000	Instalments falling due . .	7,899
Debenture stock .	500,000	Securities sold for future settlement . .	23,845
Loans from bankers	118,038	Debtors . .	6,529
Securities bought for future settlement . .	19,542	Cash . .	30
Instalments falling due . .	7,899		
Creditors	9,504		
Unclaimed dividends . .	30		
Deb. int. accrued.	4,932		
Pref. div. accrued.	2,959		
Reserve account .	20,000		
Revenue account balance . .	14,991		
	£1,697,895		£1,697,895

Here we see that out of a balance-sheet total of £1,697,895, no less than £1,683,437 consists of investments held by the Trust or sold for future delivery. There is a trifle of less than £8,000 of instalments falling due, balanced by a *per contra* liability of the same amount on the other side, an insignificant total of debtors and a tiny bit of cash.

Now let us look at the liabilities. The full

balance-sheet – the above picture of it has been slightly compressed – tells us that original capital issue was in the form of £1,000,000 in £10 shares, which have been converted into £600,000 5 per cent. preference stock and £400,000 ordinary stock. This is the usual practice of Trust companies, and those original holders who keep both their preference and ordinary stocks are not in any way affected by this conversion in the matter of income received. On three-fifths of their holding they get a dividend confined to 5 per cent., but this means that there is a larger balance available for higher dividends on the ordinary stock, or for allocations to reserve, which will increase the value of the ordinary stock and the income available for it in the future.

What usually happens when these conversions are carried out is that the price of the preference stock is quoted (in these times of dear money) somewhere between 85 and 90 and the ordinary stock goes to a small premium, owing to the expectation of higher dividends on it, and if these expectations are realized this small premium will be swollen in after years as reserves are rolled up and the income of the Trust grows with them.

Behind this preference and ordinary capital, or in front of them in security and charge on the income of the Trust, we see a loan from bankers for £118,000 odd. This facility that Trust companies enjoy of borrowing from banks, at rates which in normal times are lower than those which

they can earn on their investments, is an additional source of income for them; and one often sees in the balance-sheets of those that have no debenture debt considerably larger sums, in relation to their capital, so borrowed, than appears in this example. But as bank loans are usually arranged at a rate of interest which varies with changes in Bank rate, those companies which have made, like the one whose figures we are examining, a definite issue of debentures to a subscribing public, know better how they stand and are in a more comfortable position, especially in these days when the Bank rate nuisance is so prominent.

The debentures that they can offer to the public are evidently an excellent security for those who are not obliged to bother about a free market for their holdings. If we look at the example given by this young company, we see that the value of the investments is more than three times that of the debenture stock secured on them, after deducting from the investment total £1,659,592, the amount of the bank loan, £118,038. And this balance-sheet value of the investments is stated in the report to be below the value arrived at by a valuation made at the date when the accounts were closed. And when we come to look at the income figures, we shall find that there is a net revenue of over £67,000 to meet interest, in a full year, of £20,000 taking income-tax at its present rate of 4s. in the pound. And this is so, in spite of the fact that the full

income from the investment of the money received from the debenture subscribers does not appear to have been paid to the Trust during the year.

Preference shareholders are also comfortably covered, by investments valued at over a million (after deducting the sum of the bank loan and debenture stock) and net income of £47,000 to meet their dividend of £24,000 net; and these prior charges of the Trust companies are deservedly popular with careful investors, though the market in them is seldom very free.

But it is in the ordinary stocks that those more venturesome investors find their chance, who look for the advantages claimed for common stocks but are, with good reason, shy of the risk attached to direct investment in industrial and commercial securities. And if we look at the revenue of this company, though hardly out of its infancy, we can see how pleasantly the Trust company system works for its ordinary shareholders. The year's income from investments, less income tax, was £81,298, which means £101,623 gross, which on £1,683,000 worth of securities works out at 6 per cent. gross. With 6 per cent. earned as an average on the whole portfolio, and 5 per cent. payable on the debenture and preference stocks, and perhaps 5 to $5\frac{1}{2}$ per cent. on the Bank loans (since Bank rate was $4\frac{1}{2}$ per cent. throughout the greater part of the year) there is clearly a comfortable income available for the ordinary stockholders, after

meeting the moderate expenses involved by Trust company management. These, which include management expenses and directors' fees (£6,250), and auditors' and trustees' fees, legal, and directors' travelling expenses (£331), make a total of £6,581, which is well within the ½ per cent. of total invested funds usually taken as the limit of management cost for a Trust company.

Let us set the figures out: –

Expenses . .	£6,581	Income from investments less tax	£81,298
Bank interest .	7,182	Transfer fees .	52
Deb. int. less tax .	13,771		
Pref. div. less tax .	24,000		
Balance . .	29,816		
	£81,350		£81,350

This balance shown, of £29,816, would have sufficed to pay a dividend on the ordinary stock at the rate of 9 per cent., less tax, absorbing £28,800, and left a margin of just over £1,000. But the directors, mindful of the need for building up reserves in these difficult times and at this early stage of the company's career, follow the prudent policy and recommend a dividend of only 5 per cent., less tax, absorbing £16,000, putting £10,000 to reserve and increasing by nearly £4,000 the amount carried forward. In other words, they reinvest for the benefit of the shareholders 46·3 per cent. of the sum earned for them, and, as a very small shareholder, I am glad to see them doing so.

Two things are still to be noted. First, that since the debenture stock issue was made during the course of the year and the interest on it only came to £13,771, instead of the £20,000 that would have been required for a full year, it is probable that the full income from the investment of the proceeds was not received, which would have meant a further small addition to the balance available for the ordinary stock. Second, that no mention is made of profits from underwriting, which, in times when sound new capital issues are plentiful and being absorbed readily, often make a comfortable addition to the revenue of Trust companies.

It is stated in the directors' report that 'the net capital appreciation realized upon the sale and redemption of investments has been applied to writing off the discount and expenses of the debenture stock issue and to writing down the cost of investments.' Trust company debenture stocks are not included among the investments available to trustees, though many of them are considerably safer than some securities that have received from Parliament this questionable hall-mark, and owing to the state of the money market it has not lately been easy to issue even trustee securities on a 5 per cent. basis. Consequently, the British Combined Trust had to place its 5 per cent. debenture stock at 96. To fill the gap between this and its par value, at which it is stated in the

balance-sheet, and to meet commissions and other expenses, the profit on sales of investment has been drawn on, and the rest of it has been put to a hidden reserve by being used to write down the cost of investments. A curious shareholder might like to know how much this profit on sales and redemption of investments had brought in in the course of the year; and in the accounts of some Trust companies the amount used to be stated, while others announced it through the mouth of the chairman at the annual meeting. But in recent years the policy of reticence on this point has become more general, presumably owing to the possibility of misunderstanding by shareholders, if the amount of profit so made were to vary considerably. Under present conditions, with prices of securities shrinking beneath the 'envious sneaping frost' of monetary disturbance and uncertainties, the managers of British Trusts will be extremely skilful or extremely lucky if they succeed in producing much profit from this source in their forthcoming accounts, unless there should be some unexpected change in the state of markets before the accounts are made up. The American Trusts, which have burgeoned so brilliantly and rapidly in the sunshine and exhilarating breezes of Wall Street, have, until the October tumble came, been in a happier position in this respect. But of them more anon.

A full list of the securities and the amounts thereof held is generally published with the report,

though some of the older companies, especially in Scotland, prefer to lock the secret of their holdings in the bosoms of the board and managers. As usual, plausible reasons can be given for this policy of mystery. We are told that a Trust company should not be expected, by publishing its securities, to teach its competitors where to look for good ones, that in the case of those which follow a policy of investment activity and make frequent changes in the contents of their portfolio, a statement of the holding at a certain date is valueless and misleading, and so on. But since publicity in this matter has been proved to be compatible with excellent results, and since the case for publicity is obviously strong, it seems likely that it will win its way to universal acceptance.

A certain number of Trust companies apply the distribution principle within a limited area, confining their investments to a selection of the companies working a certain kind of enterprise. Examples are the Rubber Plantations Trust, the Tin Selection, the Scottish Tea and Rubber Trust, and so on. Such companies have done and may do extremely well for their shareholders, but as their fortunes fluctuate with those of one class of enterprise, they clearly do not give us that range of distribution that is a source of strength to the company that has no limits on the sweep of its investment net. In the early days of the movement limitation of this kind was fairly general, but

universality has won its way by its obviously greater degree of safety, and most of the British companies that originally ran in blinkers have now expanded their range of vision.

But it is time to test, by practical demonstration, the claim that I have advanced for Trust company stocks as a haven in which a puzzled investor, who likes the common stock idea but is rather afraid of it, may find a reasonably safe anchorage. Following the practice of Messrs. Smith and Raynes, let me show you what would have been the fate of an investor who, twenty years ago, put money into the ordinary stocks of nine companies of this kind. Here is a table worked out for us by Mr. Gilbert Layton of the *Economist*; allowance has been made, whenever possible, for bonus issues. But since in some cases, owing to the terms of the issues, it was not possible to be certain how much benefit the shareholder would receive, the calculation to a slight extent understates the total income and capital increase, in dividends and 'rights,' that the supposed investor would have received (see table on page 208).

This experiment begins with the period of slightly rising interest rates that preceded the War, goes on through the War with its much faster rise in interest rates and devastating fall in security prices, then through the decline in interest rates and rise in security prices from the end of 1921 till May 1928, and ends with the time of dear money

	(*a*)	(*b*)	(*c*)	(*d*)	(*e*)
	Proportion of gross Revenue available for Dividend on Ord. Stock.	Percentage of (*a*) paid to Ord. Stock holders.	Percentage of (*a*) Reserved or added to balances carried forward.	Average dividend received per £100 invested in first year.	Average market value of investment.
1909–10	41·4	82·9	17·1	5·4	100
10–11	41·1	79·8	20·2	6·1	109
11–12	44·0	77·1	22·9	6·4	122
12–13	45·0	82·9	17·1	6·7	126
13–14	46·0	77·6	22·4	6·8	126
1914–15	42·5	85·1	14·9	6·9	104
15–16	39·6	90·8	9·2	6·8	93
16–17	41·5	79·6	20·4	6·6	91
17–18	41·1	79·8	20·2	6·8	94
18–19	42·1	75·6	24·4	7·2	104
1919–20	43·5	75·1	24·9	8·1	106
20–21	47·0	70·2	29·8	8·9	104
21–22	45·9	77·0	23·0	8·8	119
1922–23	46·6	83·0	17·0	9·4	142
23–24	51·4	76·6	23·4	10·0	161
24–25	54·0	75·5	24·5	11·3	208
25–26	52·2	73·0	27·0	12·0	228
26–27	53·1	75·9	24·1	12·9	256
27–28	53·5	76·8	23·2	13·9	297
28–29	53·9	76·4	23·6	14·3	304[1]

[1] At 30th September 1929.

and falling prices, that has been lately inflicted on us by the wisdom of banking authorities abroad.

Throughout all these changes and chances of our monetary and financial life, the income received by the holder of this assortment of Trust company stocks has risen almost without a break from 5·4 per cent. to 14·3 per cent. In 1916 and 1917, the income gave a little shiver from 6·9 down to 6·8 and then 6·6 per cent., just by way of polite acknowledgment of the existence of the greatest political and financial cataclysm that ever happened; and again, in 1922, it shed ·1 per cent. to mark the collapse of the after-war boom; but otherwise it pursued the even tenor of its upward way, with an increase in every single year.

Average market value, though showing much wider intermediate fluctuations, has, over the whole course, slightly out-distanced the rise in income. When the imaginary investment was first made it yielded the buyer £5, 8s. per cent. At the market price of 30th September 1929, an aggregate purchase of the same stocks would yield £4, 14s. per cent. Before the scramble for gold and the consequent squeeze in money set in, market values of Investment Trust company stocks were considerably above the level of 30th September last. The growing recognition of their virtues had lifted their prices so high that even after the recent reaction in their prices, they gave a lower yield to

the buyer, at the end of September, than a large number of 'trustee' securities.

This low yield on Investment Trust stocks is accounted for by the expectation of higher returns in years to come, and by the greater attention that is paid in these days to the rate earned rather than the rate paid. On the basis of rate earned the story is quite different, as is shown by the following table setting the companies out in detail (see table on page 211).

Going back to the first table it is important to note the fluctuations in the percentage of revenue put to reserve or added to carry-forward. Looking, as one always should, for weak points in this exhibition of Investment Trust company strength, we may fasten on the decline in this percentage in the last three years from the high point of 27 per cent., touched in 1926. There may be some reason for this, such as large transfers to hidden reserves of profits made by sales of securities; and the percentages reserved from revenue in the last three years have at least been above the average for the whole period, which works out at 21.5 per cent. But even so, one does not like to see this percentage declining, for generous allocations to reserves from revenue have done yeoman service in the past in building up the earning power of the Trust companies, and the maintenance of this policy is all-important for the future.

	Price 30th September 1929.	Yield on basis of last dividend.	Yield on basis of dividend that might have been paid on latest profits.
		£ s. d.	£ s. d.
British Investment Trust . .	445	4 14 0	6 1 4
Edinburgh Investment Trust .	290	4 2 9	5 13 10
Foreign and Colonial Investment Trust	192½	5 4 0	7 5 5
Industrial and General Trust .	345	5 1 6	6 7 6
Investment Trust Corporation .	460	4 7 0	5 13 1
London Trust	395½	5 1 9	6 6 3
Mercantile Investment and General Trust	312½	5 2 6	6 11 3
Metropolitan Trust . . .	412½	4 14 6	5 13 9
Omnium Investment . . .	170	5 17 9	8 10 8

CHAPTER XIII

THE ROCKS IN THE HAVEN

Trust Companies' Lurid Past – Dangers in the Future – Management and Supervision – Trying to be too Clever – Trust Companies in America – Their Amazing Growth – In an Intoxicating Atmosphere – Co-operative Investment Trusts – Wanted, A Wage-earners' Trust – Under the Highest Auspices – Conclusion.

In the best of havens there may be rocks and currents and other things that may discomfit the incautious mariner. Let us see what is the worst that can be said about the future of the Trust companies. If we revive that Rip van Winkle stockbroker, whom we imagined, at the beginning of Chapter VIII, waking after a thirty years' sleep to find common shares for safety a popular cry, he would probably express himself vigorously on the subject of the recent rapid expansion of the Trust company principle. 'Trust companies!' he would say with a comprehensive sniff, 'I know all about those beautiful arrangements! In the early 'nineties the City simply reeked with the disclosures that came to light when they had to be reconstructed and cleaned. They had founders' shares which put preposterous profits into the pockets of the philanthropists who had started them, and then paid

ridiculous dividends, out of which they took their exaggerated whack, by investing in speculative stuff that they ought never to have looked at. Some of them were "relief funds" organized to enable financial houses, up to their chins in rubbish, to unload it on to the unfortunate public. Some of them – '

When we have calmed him down and reminded him that all this happened a long while ago, that the lessons then learnt have been read, marked, and inwardly digested, and that the Trust companies can show a record of almost uniform success through the most difficult quarter of a century that has ever been inflicted upon the world of finance, he will quickly start again on a fresh tack. He will tell us that the Trust companies are now so many, and the capitals of many of them are now so big, that it is not possible to provide efficient supervision of the immense mass of securities that they collectively hold; that the principle of diversification is all very well within limits, but that if it means that a company has so many hundreds of investments that it has not enough eyes to watch them, it will lead to more trouble than the old system of having many eggs in a few baskets, and then watching the baskets carefully. He will remind us that in the half-dozen years before the money market began to get uncomfortable, there was an almost continuous rise in the average prices of securities, shown by the *Investors' Chronicle's* Monthly

Securities Index which, for all classes of stocks, was 78·2 on 31st December 1921, and had risen to 135·1 on 25th May 1928, an advance of more than 70 per cent.; and he will argue that the taste for exaggerated capital profits, which this period of easily earned appreciation has cultivated, has demoralized the Trust company experts and made them too greedy; and that consequently they will easily be tempted to try to be too clever, now that falling markets, with the *Investors' Chronicle's* Index back to 117·9 (30th September 1929) for all securities, have made such profits difficult to come by; and he will assert, with much of the strong language that was so rife in the City in the last century, that though the young men of to-day think themselves amazingly clever, trying to be too clever has always been the worst mistake that a business man can make.

As for America, he will see all these dangers repeated and exaggerated on the immensely expanded scale that is there so popular. The pace of creation, he will say, has been much too terrific; half a dozen years ago investment companies of this kind were unknown in the United States, and now (quoting a New York cable in *The Times* of 17th September 1929) it is estimated that the total of investment trust funds will be equal to $3,000,000,000 before the end of the year; and he will want to know whether it is likely that sound and experienced management can have been

provided, in the twinkling of an eye, for the careful investment of £600,000,000. And there, of course, he will add, the rise in security prices has been much more violent – 260 per cent. in common stocks since August 1921 – and the managers of all these young Trusts, brought up on this heady diet, have been tempted and trained – almost compelled – to grow into gamblers, not investors. In fact, he will tell us as a parting shot, the Trust companies and the market have been engaged in a game of mutual demoralization in Wall Street, the Trust companies boosting the market and the market boosting the companies, and a nice kettle of fish they have been frying for one another; in proof of which he will quote us a cable in the *Daily Telegraph* of 23rd September 1929, saying that 'there is no particular reassurance in the fact that the buying has been conducted largely by the huge investment trusts, which have grown up like mushrooms in the past few months. The remarkable public appetite for the securities of investment trusts, or, as they should more properly be called, trading and holding companies, has made their extraordinary growth possible.'

That there is a certain danger in the rapid growth of American Trust companies, and in the extent of their market operations, is evidently the opinion of an eminent American financial authority, Mr. Paul Warburg, who is quoted as having lately referred to them as 'some of the subtlest elements of inflation

– incorporated stock pools, called "investment trusts." '

On the other hand we have Professor Irving Fisher, of Yale University, well known for his strenuous work for monetary stabilization, saying in the *North American Review* for July 1929, that 'in truth investment trusts are just the opposite of dangerous. They represent not only expert knowledge, such as that to which the older investment houses can lay claim, but two other safeguards – diversification and incessantly vigilant management,' and we might add (when they are sound) that put-a-bit-away-every-year policy, which the investor finds so difficult to carry out for himself.

Here we have a distinguished practical financier denouncing the American Trust companies as dangerous, and a high economic authority saying that they are the very opposite. And both are right, for in fact Trust companies, in all climates and countries, are like the little girl in the nursery rhyme, who

'When she was good she was very, very good,
But when she was bad she was horrid.'

The best of them that stick to the three great principles: –

(1) diversification, wide enough but not too wide,
(2) all capital profits put away,

(3) a proportion of income from interest and dividends, also regularly ploughed back into the field,

those that follow these lines with expert investment skill behind them, can do much better for the average investor than he can hope to do for himself. But those that work on other lines, seeking for capital profits in questionable ways, such as market manipulation, and justifying Mr. Warburg's description of them as incorporated stock pools, merit all that he has said of them as an element of stock-market inflation.

Coming back to Great Britain, the practical proof that was given at the end of the last chapter has shown what the genuine Investment Trust companies have done for their shareholders in the course of a period in which the financial structure of the whole world has passed through, and more or less weathered, unprecedented difficulties. Can they do as well in the years that are to come? It seems probable that their recent expansion in income has been helped very materially by the general rise in security values that was continuous from 31st December 1921 to 25th May 1928, as shown by the *Investors' Chronicle's* Index. Profits from the sale of securities, re-invested, have made comfortable additions to earnings, and future reports, covering the period of reaction, may show a much less favourable rate of growth. The prices

of the common stocks of many of the leading companies have, indeed, already reflected the decline in the market values of their holdings, though the fall in Trust company stocks has doubtless been partly due to sales enforced upon holders by unfortunate experiences in other markets.

Also, it is pointed out that the future is unusually uncertain and difficult, and that no one can see what will be the end of this absurd and unnecessary scramble for gold, lately indulged in by the banking authorities of America, France, and Germany, and resisted by the Bank of England as long as it thought that resistance was possible. Who shall say how many dreary acts of this farce we have yet to witness and what their effect will be on the prices of securities and consequently on those of Investment companies?

At the moment – I enter this last lap on 30th September 1929 – these melancholy vaticinations look infernally near the mark. But it is hardly credible that, at this stage in our civilization, central bank policy will continue long to discredit the gold standard in the eyes of the business community. And whatever happens, unless investors are going to give up the game altogether and put their money under the mattress or disburse it in cheery dissipation, they will surely find that the good Trust companies can do better for them than they can do for themselves.

One objection to them as a means of investment, is the high premiums at which many of their stocks stand, and the lack of freedom in the market, and the consequent difficulty that people of small means find in putting funds into them. But many Investment Trusts have in recent years been formed under the Industrial and Provident Societies' Act, with 2s. shares which the public can buy direct from the companies. These concerns have certain great advantages. Their initial expenses, so heavy for companies formed under the Companies' Acts, consist of a registration fee of £10, and perhaps £10 more for printing and other costs, and they are not subject to income-tax, though their shareholders, if their total income brings them within the Inland Revenue net, have to pay it themselves. Some of these companies have been extraordinarily successful in collecting a large aggregate capital in small amounts – no one is allowed, under the Act, to have more than £200 in any one company, though this limit may shortly be raised to £400. Institutions of this kind, if well and carefully managed, might do a great work in saving small investors from the sharks who prey on them, and in giving the working classes a chance of sharing in financial profits and of acquiring a widened interest in industry. The social and political benefits of such a development are so obvious that they go without saying.

But though I should be the last to imply any

disrespect to the boards of the existing trusts of this kind – I am on the board of one myself – they do not carry enough weight with the general public to do the work that I want to see done. What we want is an investment company fathered by the leaders of the financial world, in the shares of which employers of labour can, with complete confidence, recommend their workers to put their funds. One hears tragic accounts of the losses of working-class folk in the securities of companies like Armstrongs, once regarded in their neighbourhood as just as good as Government stocks. What is wanted is a medium in which industrial workers can put their savings into industry, through an investment company, without running the risk attached to an investment in any one industrial concern.

For such a suggestion I have the authority of Mr. A. M. Samuel, at that time Minister for Overseas Trade, who in a speech at Preston, reported in *The Times* of 2nd March 1927, referred to the great success of the Investment Trust companies and went on to suggest that a similar organization should be established as a 'wage-earners' investment trust fund.' His notion was, however, that the wage-earners' leaders, selected from different industries, should be the directors of the fund; but one may venture to doubt whether they would be possessed of, or easily able to secure, in the midst of their many pre-occupations, the necessary

financial information for carrying out such work.

In America, however, an Investment Trust owned by a Trade Union has already appeared – Amalgamated Investors Inc., owned and controlled by the Amalgamated Clothing Workers of America. An account of the successful start of this very interesting concern will be found in the Revised Edition of Dr. L. L. Robinson's book on *Investment Trust Organization and Management*. Also a proposal for a great investment company for industrial wage-earners has lately been put forward by Mr. Raskob, a director of the General Motors Company. His notion, as described in rather sketchy cablegrams, was to confine the company's holdings to common stocks, which seems an unnecessary restriction, and rather questionable owing to the height to which common stock prices had been carried in Wall Street. Anything of this kind that is done, wherever it is done, will have to be done after most careful consideration and in the purest odour of sanctity.

So much so, that for England I sometimes dream of a small savers' Investment Trust company with a Board composed, let us say, of the Governor of the Bank of England, the chairmen of the Big Five banks, and representatives of the leading issuing houses and insurance companies. Not because such a Board would necessarily be the best people to do the investing job, but because they would know the

right men to get to do the work, and would be held responsible if it was not done right. If all small investors knew that there was a sure and safe resting-place in which they could put their funds with confidence, and rely on getting from it something like the advantages that the old Trust companies have showered on their shareholders, they would be saved from temptations which too often cost them dear.

Or again, it was suggested in the course of the discussion on Mr. Raynes's paper at the Institute of Actuaries referred to in Chapter IX that the Insurance Companies might pool the investment side of their business, forming what would be a great Investment Trust company to invest the funds of all of them. If this could be done and the resulting company could be induced to conduct, as a side-line, a Co-operative Trust under the Industrial and Provident Societies' Acts for wage-earners and other small investors, then the small saver would have a chance of securing, through a safe medium, some share of the profits of industry and finance. As it is, if they are inclined to wander from the austere field of Post Office and Savings Certificate investments, and to widen their vision beyond the narrow if highly respectable horizon of the Building Societies, they are only too likely to take turnings that will land them in loss. To them, and to the great majority of wealthier investors, Investment Trust companies, if managed on the

lines indicated in Chapter XII., provide the best means of securing in safety the advantages that have been shown to follow a purchase of common stocks and shares rather than fixed-interest securities. These lines were those of skilled and careful diversification within the limits imposed by the need for vigilance, and the addition to reserve funds, hidden or visible, of all profits made by sales, and of a substantial proportion of the annual revenue from interest and dividends. This policy secures for holders of the companies' common stocks and shares a rising income and increasing capital value, by the steady operation of compound interest.

Does this mean that we should put our all into Investment Trust common stocks? It will be remembered that Mr. Raynes, as noted on p. 139, when he came to answer the question raised by his paper – what should be the place of ordinary shares in the investment of life-insurance funds, did not commit himself to naming the definite proportion that they should cover of the total holding. He said that it must, to be of real benefit, represent a significant fraction of the whole, but that ordinary certainly cannot altogether take the place of fixed interest stocks. So he left us, as most wise counsellors do, straddled over a compromise, with one leg on fixed interest and one on ordinary securities. I have ventured to carry his argument a step further and to apply it to the average investor, suggesting

that, if he has been convinced by the proofs of the benefits to be got from common stocks, he will seek them more safely in the common stocks of the genuine Investment Trusts, than in ranging over the field, so full of tares and thistles, of industrial venture.

'Thus sang the uncouth swain to the oaks and rills,
While the still morn went out with sandals grey,
He touch'd the tender stops of various quills,
With eager thought warbling his Doric lay:
And now the sun had stretch'd out all the hills,
And now was dropp'd into the western bay;
At last he rose, and twitch'd his mantle blue:
To-morrow to fresh woods, and pastures new.

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